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## **Summary:**

*My name is Pascal Malik and my thesis topic is, “The Resource Curse in Post-Soviet Countries: the case of Azerbaijan.” The objective of this Thesis is to establish whether or not Azerbaijan is currently, or may in the future, be suffering from the “resource curse.” The aim is to identify and analyze multiple economic indicators which may contribute to the development of the “resource curse” in Azerbaijan. An analysis is done on the economic reasons for the resource curse as well as an analysis of the symptoms of the resource curse and their presence and effect on the economy of Azerbaijan. The scope of this thesis is limited to one of the three aspects of the resource curse, the economic element, the other two, not covered in this research, are the social and political aspects.*

*The research in this thesis is based strongly on statistical data as well as economic principles. This data is used to analyze the reasons for the “resource curse” such as Dutch Disease, fluctuations in commodity prices, underemployment and poverty, and the limitations of oil and gas resources, and determine to what extent these are applicable to Azerbaijan. Furthermore, this thesis links the symptoms of the “resource curse” such as loss of competition, deindustrialization in non-oil sectors, weakness of the agricultural sector, tradable vs. non-tradable goods and inefficient government spending to the economy of Azerbaijan. The third part of the thesis analyzes the methods employed by the government and civil society to mitigate the effects of the “resource curse” in Azerbaijan.*

*In conclusion, this thesis identifies weakness in the economic sector of Azerbaijan and suggestions are made on how to further improve the current methods of mitigation employed by the government and civil society to ensure the sustainable development of the economy, particularly the non-oil sectors which are those that suffer most from effects of the “resource curse.”*

## **Xülasə**

*Mənim adım Pascal Malikdir və mənim tezis mövzumu “Keçmiş Sovet ölkələrində resurs lənəti: Azərbaycan nümunəsi”dir. Bu tezin məqsədi Azərbaycanın indi və ya gələcəkdə “resurs lənəti”ndən əziyyət çəkib çəkməyəcəyini müəyyənləşdirməkdir. Məqsəd Azərbaycanda “resurs lənəti”nə səbəb olan amillərin iqtisadi göstəricilərini müəyyən etmək və analiz etməkdir. Resurs lənətinə səbəb olan iqtisadi səbəblər üzrə, həmçinin resurs lənətinin simptomlarının analizi və onların Azərbaycan iqtisadiyyatında mövcudluğu və təsiri üzrə analiz aparılmışdır. Tezin miqası resurs lənətinin üç aspektindən ancaq birini, iqtisadi amilini əhatə edir. Bu tezisdə əhatə olunmayan digər iki amil ictimai və siyasi amillərdir.*

*Bu tezisdəki araşdırma tamamilə statistik məlumatlara və iqtisadi prinsiplərə əsaslanır. Bu məlumatlar, Holland Sindromu, malların qiymətində qeyri-sabitlik, işsizlik və yoxsulluq, neft və qaz ehtiyatlarının məhdudiyyətləri kimi “resurs lənətlərinin” səbəblərini araşdırmaq və bunların nə dərəcədə Azərbaycana tətbiq oluna biləcəyini müəyyən etmək üçün istifadə olunur. Bundan başqa bu tezis “resurs lənətinin” rəqabətin itməsi, qeyri-neft sektorunda sənayenin rolunun azalması, kənd təsərrüfatı sahəsinin zəifləməsi, satılan malların satılmayan mallarla müqayisəsi kimi simptomlarını və hökumətin Azərbaycan iqtisadiyyatına qeyri-kafi pul ayırmasını əlaqələndirir. Tezin üçüncü hissəsi Azərbaycanda “resurs lənətinin” mənfi təsirlərini aradan qaldırmaq üçün hökumət və cəmiyyət tərəfindən tətbiq olunan üsulları araşdırır.*

*Nəticədə, tezis Azərbaycanın iqtisadi sektorunun zəifliyini üzə çıxarır və iqtisadiyyatın, xüsusilə də “resurs lənətinin” təsirindən daha çox əziyyət çəkən qeyri-neft sektorunun davamlı inkişafı üçün hökumət və cəmiyyət tərəfindən tətbiq olunan indiki üsulların gələcəkdə necə təkmilləşdirmək yollarını göstərir.*

## **Abbreviations:**

ACG – Azeri-Chirag-Gunashli oil fields

AMG – Asset Management Guidelines

AZN – Azerbaijan Manat (National Currency)

bbl. – Barrel of Oil (bbl./day)

BP – British Petroleum

BTC – Baku-Tbilisi-Ceyhan

BTK – Baku-Tbilisi-Kars Railway

EITI – Extractive Industries Transparency Initiative

EU – European Union

FDI – Foreign Direct Investment

GDP – Gross Domestic Product

IMF – International Monetary Fund

IOC – International Oil Company

NGO – Non-Governmental Organization

NRF – Natural Resource Fund

OPEC – Organization of Petroleum Exporting Countries

PFMC – Public Finance Monitoring Centre

PWYP – Publish What You Pay

REER- Real Effective Exchange Rate

S.U. – Soviet Union

SOCAR – State Oil Company of the Republic of Azerbaijan

SOFAZ – State Oil Fund of the Republic of Azerbaijan

UAE – United Arab Emirates

US- United States

USSAC – US-Azerbaijan Chamber of Commerce

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## **Introduction:**

A frequently debated problem worldwide is that many extractive sector countries experience an economic paradox resulting from their resource wealth. In mineral and oil rich countries this phenomenon has been given many names among which are, “the paradox of plenty”, “economic indigestion”, “the devil’s excrement” and the most commonly used, “the resource curse”.

The paradox lies in the fact that, despite their abundant resources, the economies of these countries have proven over time to do worse than countries which do not have such resource wealth. Resource-led development does not only seem to fail in boosting economic growth but in many cases it has been established that the economic and social situation in these countries often ends up worse than before the extraction of resources began.<sup>1 2</sup>

In the 1970’s, prior to massive increases in oil prices on a global scale, due to action undertaken by OPEC, the price per barrel of oil was at \$3; in 1980 the price had reached a stunning \$30 per barrel.<sup>3</sup> Prior to this price jump, the economies of oil rich countries were developing at a similar rate, but studies show that between 1960 and 1990 oil poor countries had GDP per capita growth rates that were 2 to 3 times higher.<sup>4</sup>

This paradox has been the focus of much research since the 1980’s and the term “resource curse” was used for the first time in economics literature in 1993 by Richard Auty.<sup>5</sup> As can be seen above, the “resource curse” leads to poor economic growth but there are also many other factors to consider. The resource curse affects resource rich countries on three fronts, economic, social, and political. It has been observed that the resource curse can lead to such problems as greater

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<sup>1</sup> Open Society Institute. Follow the Money: A Guide to Monitoring Budgets and Oil Revenues. 2004.

<sup>2</sup> Overseas Development Institute (ODI). “Meeting the Challenge of the Resource Curse: International Experiences in Managing the Risks and Realising the Opportunities of Non-Renewable Natural Resource Revenue Management.” January 2006. <http://www.odi.org.uk/resources/download/587.pdf>

<sup>3</sup> Jeffrey Sachs and Andrew Warner, “Natural Resource Abundance and Economic Growth,” Development Discussion Paper no.517a, Harvard Institute for International Development, 1995.

<sup>4</sup> Svetlana Tsalik, of the Caspian Revenue Watch. Caspian Oil Windfalls: Who will Benefit? Copyright 2003 by Open Society Institute.

<sup>5</sup> Richard M Auty. “Sustaining Development in Mineral Economies: The Resource Curse Thesis. London: Routledge.” 1993.

poverty, slower development, corruption, weaker democracy and in extreme cases even violence and civil war.<sup>6</sup>

The causal factors behind the resource curse are varied and numerous. Probably the most significant of these factors is known as “Dutch Disease.” This term was coined by The Economist in 1977 to describe the decline of the manufacturing sector in the Netherlands (Groningen) after the discovery of natural gas in the 1960’s.<sup>7</sup> Other factors contributing to the “resource curse” include fluctuations in commodity prices, non-renewability of resources, underemployment, price shocks/volatility and governance.

Economists have been working on solutions to mitigate the effects of the “resource curse” and according to *Weinthal* and *Luong* the most popular solutions emphasize macroeconomic policies, economic diversification, natural resource funds, transparency and accountability, and direct distribution to the general population.<sup>8</sup>

Since its independence in 1991, Azerbaijan has flourished economically due mainly to its extensive resources in oil and gas. The questions that must be addressed are, whether or not this economic growth is sustainable and what the government can do to ensure the economic stability in the future. Oil and gas are non-renewable resources; Azerbaijan’s government must act today to ensure its country’s well-being after its natural resources run out. The aim of this research paper is to identify whether Azerbaijan is currently, or on its way to, suffering from the “resource curse” by analyzing the economic reasons for the resource curse as well as the economic symptoms. Furthermore an analysis of how to mitigate the resource curse will be made with attention to the specific case of Azerbaijan. Given Azerbaijan’s relatively recent independence from the Soviet Union, this case may be useful for other newly independent, resource rich, states in the region.

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<sup>6</sup> Open Society Institute. *Follow the Money: A Guide to Monitoring Budgets and Oil Revenues*. 2004.

<sup>7</sup> Ingilab Ahmadov, PhD. PowerPoint: Oil Factor’s impact to economy, Dutch Disease. Khazar University 2009/2010.

<sup>8</sup> Erika Weinthal and Pauline Jones Luong (2006). *Combating the Resource Curse: An Alternative Solution to Managing Mineral Wealth*. *Perspectives on Politics*, 4, pp 35-53 doi:10.1017/S1537592706060051

## **Chapter 1 – International Examples of the Resource Curse and its Mitigation:**

This chapter will discuss experiences with the resource curse in resource rich countries around the world. The main cases observed are those of Saudi Arabia, Iran, Indonesia, Malaysia and Botswana. It includes a brief discussion of the effects and the methods used to mitigate the resource curse in the different countries. The aim is to provide some information for the better understanding of the resource curse, its effects, and the way to mitigate them.

The “resource curse” is visible in a large percentage of resource rich countries. One of the most common examples is on the continent of Africa where many resource rich countries have experienced the political, social and economic repercussions resulting from their dependence on their extractive industries, ranging from minerals to oil and gas. Many sub-Saharan African states are plagued with war, poverty, unemployment, lack of industrial diversity, lack of transparency and many other factors common to the “resource curse.” Nigeria shows a classic case of the “resource curse”.

When considering the oil and gas industry, the most obvious example of the “resource curse” is in the Middle East. Countries like Saudi Arabia, Qatar, the UAE, Bahrain, and others, are highly dependent on non-tradable industries and oil and gas. These states are vulnerable to shifts in oil prices and have accrued massive amounts of national debt as a result.

Saudi Arabia is an ideal example of this fact. “Saudi Arabia’s industry sectors are dominated by petrochemicals and petrochemical based products. The main industries in Saudi Arabia include crude oil production, petroleum refining, ammonia, industrial gases, sodium hydroxide, fertilizers, cement, plastics, metals, construction, commercial ship and aircraft repair.”<sup>9</sup>

GDP in Saudi Arabia grew at an average of 1.25 percent per year from 1981-2001, furthermore average GDP per capita shrunk approximately 2.5 percent per year.<sup>10</sup> In Saudi Arabia GDP per capita was higher in 1965, before the massive rise in the price of oil than in 1999.<sup>11</sup> Okaz, a

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<sup>9</sup> Economy Watch. “Saudi Arabia Industry Sector.”

[http://www.economywatch.com/world\\_economy/saudi\\_arabia/industry-sector-industries.html](http://www.economywatch.com/world_economy/saudi_arabia/industry-sector-industries.html)

<sup>10</sup> World Bank . “Country at a Glance: Saudi Arabia,” September 23, 2002.

<sup>11</sup> Eric Swanson, et al., World Development Indicators, 2001 (Washington, D.C.: World Bank, 2001), pp. 24-26.



Saudi news agency, stated that in 2002 that the nominal GDP per capita went from \$10,330 in 1989 to \$7,743 in 2001.<sup>12</sup>

“Additionally, a review of the Saudi economy by the International Monetary Fund indicates that, with the exception of the year 2000, in which the overall central government budget registered a sharp turnaround due largely to a rise in oil prices, “in every other year, the budget has run a deficit and the debt stock has run up to \$170 billion, which is equal to the size of GDP.”<sup>13</sup> (By comparison, in the European Union, the ratio of public debt to GDP is restricted to 60 percent.)”<sup>14</sup>

Another case of the resource curse can be found in Iran, according to Mehdi Parvizi Amineh, “...Iran did not create a globally competitive manufacturing or service sector; while collusion between the government and major oil and gas companies, corruption and revenue mismanagement wasted income from oil and gas exports and made the economy dependent on them. This close relationship between Iran’s oil revenues and its GDP seriously threatens economic growth by making it susceptible to ‘Dutch Disease’.”<sup>15</sup>

In general, smaller countries are more susceptible to the resource curse as they “...have less developed alternative sectors to off-set the effects of revenue volatility and/or long term decline in production.”<sup>16</sup>

In spite of the abundance of negative impacts on resource rich countries throughout the world, there are some countries that have dealt well with their plentiful resources on an economic level. According to the World Bank, Indonesia, Malaysia and Botswana are three solid examples of countries that have “achieved impressive economic gains despite their resource abundance.”<sup>17</sup>

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<sup>12</sup> *Okaz*, October 19, 2002.

<sup>13</sup> "Article IV Consultation with Saudi Arabia." International Monetary Fund. November 7, 2001.

<sup>14</sup> MERIA (Middle East Review of International Affairs). "SAUDI ARABIA: A BRIEF GUIDE TO ITS POLITICS AND PROBLEMS." Volume 7, No. 3 - September 2003.

<sup>15</sup> Mehdi Parvizi Amineh, of the International Institute for Asian Studies. "The Resource Curse: Oil-based Development in Central Asia." IIAS Newsletter # 4 2 Autumn 2006.

<sup>16</sup> Overseas Development Institute (ODI). "Meeting the Challenge of the Resource Curse: International Experiences in Managing the Risks and Realizing the Opportunities of Non-Renewable Natural Resource Revenue Management." January 2006. <http://www.odi.org.uk/resources/download/587.pdf>

<sup>17</sup> World Bank. Petroleum Sector Brief Note. "Avoiding the Resource Curse." No.3, May 2007.

Before the oil boom of 1973-1974, Indonesia was in bad shape. In 1966, a military regime rose to power, there was omnipresent corruption, a low adult literacy rate and high levels of linguistic and ethnic diversity which are known causes of conflict.<sup>18</sup>

During this period, the mid 1960`s, Indonesia was considered one of the poorest countries in the world with huge government deficits and hyper-inflation, just under 1,500 percent a year at its highest. Despite the military government, with the president having high levels of power, Indonesia`s government was able to stave off the resource curse by giving priority to economic growth, emphasizing infrastructure, education, capital intensive industry and most importantly for the country`s economy, the government invested an unusually high proportion of government spending in the agricultural sector (about 20 percent). Furthermore the country`s economic advisors focused on achieving macro-economic stability and tightly controlling inflation and budget deficits which resulted in a steep decline in inflation by 1969.<sup>19</sup>

“When oil prices fell in the early 1980s, the government reacted swiftly with a series of measures that combined expenditure reduction, exchange rate devaluation in 1983 and 1986, and economic reform. The response was dramatic. Between 1983 and 1992, the share of manufactures in total merchandise exports rose from 7 percent to nearly 50 percent. Some officials have even come to regard the collapse of world oil prices as a blessing in disguise.”<sup>20</sup>

The actions taken by the Indonesian government were not all good and Indonesia suffered greatly from the 1997-98 Asian financial crisis, some say more than other Asian countries, but in the long run Indonesia has outperformed other resource rich countries and “...has overcome unfavorable initial conditions and temptations to squander oil windfalls to achieve impressive economic gains.”<sup>21</sup>

Malaysia is also a resource rich country but not just in oil, it also possesses significant reserves of rubber, tin, and palm. One of the key elements that lead to Malaysia`s success in avoiding the

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<sup>18</sup> Ibid.

<sup>19</sup> Ibid.

<sup>20</sup> Ibid.

<sup>21</sup> Ibid.

“resource curse” was the high savings rate that allowed capital to be made available for investment.<sup>22</sup>

“Government expenditures favored education, housing, and health, and achieved a geographically balanced distribution.” Furthermore, a compulsory savings scheme was set up which required workers to set aside money. Malaysia’s government also promoted economic diversification and export-oriented industrialization to avoid developing a dependence on the extractive sectors. The focus, during the early stages of development, was on the development of labor intensive industrialization which allowed the use of the extensive pool of workers from rural areas. As the manufacturing sector expanded rapidly, due to foreign investment from international firms interested in low labor costs, the government invested heavily in education to fill the demand for skilled workers.<sup>23</sup> These investment showed their success as enrollment in secondary education tripled from 1960-1990.<sup>24</sup>

Botswana achieved independence in 1966, at which time it was a very poor nation. However it was rich in gem-quality diamond and now ranks among the most successful resource rich countries in the world.<sup>25</sup> This is due to prudent fiscal policies with regards to revenues obtained from the extraction of diamonds. Major parts of the profits from diamond mining have been invested in infrastructure development, education health and agriculture.<sup>26</sup> It must also be considered that diamond prices are less volatile than those of oil.

Furthermore the government of Botswana developed an index, the budget sustainability ratio, to assess its fiscal performance. “It is the ratio of non-investment spending (that is, consumption) to non-mineral revenue. A ratio greater than unity indicates that the government is using mineral revenues to finance consumption, which is unsustainable in the long run.”<sup>27</sup>

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<sup>22</sup> Ibid.

<sup>23</sup> Ibid.

<sup>24</sup> Auty, R.M. “*Resource Abundance and Economic Development*.” 2001. Oxford: Oxford University Press.

<sup>25</sup> World Bank. Petroleum Sector Brief Note. “Avoiding the Resource Curse.” No.3, May 2007.

<sup>26</sup> Ibid.

<sup>27</sup> Ibid.

“Indonesia, Malaysia, and Botswana have all relied on highly trained technocrats and given them relative autonomy to run the economy. These examples illustrate that the resource curse is not inevitable, but also that a strong political will and commitment to sound economic policies, sustained over many years, are needed to avoid it.”<sup>28</sup>

## **Chapter 2 – A Brief Overview of Azerbaijan’s Oil History:**

This chapter will discuss the particularity of Azerbaijan as a post-Soviet country. Azerbaijan’s extensive history as an oil and gas producing state played an important part in defining the country’s role during the Soviet era. Furthermore, the evolution of Azerbaijan that has occurred since its independence is briefly discussed.

Azerbaijan has a very long history of oil production spanning back to the 10<sup>th</sup> century A.D. It is believed that Azerbaijan was one of the first countries in the world to recognize the medicinal and household uses of oil. Since the 10<sup>th</sup> century A.D. oil was extracted from the ground by hand digging 10 to 12 meter wells, by the beginning of the 17<sup>th</sup> century, the capital of Azerbaijan, Baku, was surrounded by approximately 500 wells.<sup>29</sup>

Simple refining began in Azerbaijan in the 13<sup>th</sup> century, with the acquisition of low-density oil fractions for use in indoor and outdoor lighting. Industrial refining began in 1820’s and the first oil-refining plant which produced kerosene from oil was built in Baku in 1863. By 1873, about 50 oil refineries existed in Baku. Azerbaijan was the first country to obtain oil from the ground by drilling oil wells. The first oil well was drilled in Baku between 1848 and 1849.<sup>30</sup>

Azerbaijan started to attract interest from foreign investors in 1872, when foreign businessmen and businesses, such as the Nobel brothers and the Rothschild’s Bank House, began to acquire

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<sup>28</sup> Ibid.

<sup>29</sup> Huseynov. “Oil Policy and Strategy of Azerbaijan“. Caspian Region Workshop. Applicability of Norway’s socio-economic and political strategy as Oil-State for the Caspian Region. 2-3 February 2006, Berlin.

<sup>30</sup> BBC News. “Timeline: Azerbaijan.” [http://news.bbc.co.uk/2/hi/europe/country\\_profiles/1235740.stm](http://news.bbc.co.uk/2/hi/europe/country_profiles/1235740.stm)

oil-rich areas on the Absheron peninsula by tender.<sup>31</sup> The Nobel brothers set up an oil-production company in 1879.<sup>32</sup>

As a result of this surge in foreign investment, between 1885 and 1920, Azerbaijan experienced an oil boom. “Azerbaijan was [ranked] first in the world in the total amount of oil produced from 1899 to 1901...made up more than 50% of the world's production. Oil production in the U.S.A., at that time amounted to only 9 million tons per year.”<sup>33</sup>

The boom was short lived though as the invasion of Azerbaijan by the Bolsheviks in 1920 led to the confiscation of all private property such as oil wells and factories. Following this, Azerbaijan’s entire oil output was used to fuel the Soviet Union, especially during the WWII.<sup>34</sup> Azerbaijan gained independence from the Soviet Union in 1991, during the 70 years of soviet reign Baku produced a large percentage of the Soviet Union’s oil and gas. When the Soviet Union collapsed, Azerbaijan was left with very few, if any, political and economic institutions, as during the Soviet era all the power was centralized in Moscow.

In 1994, Azerbaijan signed what came to be known as the “contract of the century” with a consortium of international oil companies, for the exploration and exploitation of three offshore oil fields Azeri, Chirag and the deep-water Portion of the Gunashli (ACG). ACG is located in the Azerbaijan sector of the Caspian Sea about 120 km south east of Baku, the Contractual area covering about 432.4 sq. km.<sup>35</sup> Estimated oil reserves were about 5.2 billion barrels of recoverable oil with an additional accumulation of 96 billion cubic meters of associated gas.<sup>36</sup>

The consortium consisted of 11 companies, the three biggest investors were SOCAR, the national oil company of Azerbaijan (20 percent), BP (17 percent), and Amoco (17 (percent)).<sup>37</sup>

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<sup>31</sup> Huseynov. “Oil Policy and Strategy of Azerbaijan“. Caspian Region Workshop. Applicability of Norway’s socio-economic and political strategy as Oil-State for the Caspian Region. 2-3 February 2006, Berlin.

<sup>32</sup> BBC News. “Timeline: Azerbaijan.” [http://news.bbc.co.uk/2/hi/europe/country\\_profiles/1235740.stm](http://news.bbc.co.uk/2/hi/europe/country_profiles/1235740.stm)

<sup>33</sup> Huseynov. “Oil Policy and Strategy of Azerbaijan“. Caspian Region Workshop. Applicability of Norway’s socio-economic and political strategy as Oil-State for the Caspian Region. 2-3 February 2006, Berlin. [http://userpage.fu-berlin.de/ffu/veranstaltungen/caspian\\_region\\_workshop06/Huseynov.pdf](http://userpage.fu-berlin.de/ffu/veranstaltungen/caspian_region_workshop06/Huseynov.pdf)

<sup>34</sup> Mir Yusif Mir-Babayev. Azerbaijan's Oil History: A Chronology Leading up to the Soviet Era. Summer 2002 (10.2) Pages 34-40.

<sup>35</sup> SOCAR. [www.socar.az](http://www.socar.az)

<sup>36</sup> BP. “Azeri-Chirag-Gunashli (ACG) contract”: [www.bp.com/caspian](http://www.bp.com/caspian)

<sup>37</sup> Ibid.

This was the first in a series of events that would change the global role of Azerbaijan economically and geo-politically.

The ACG contract was the first of 33 production sharing agreement (PSA) contracts which have been established to date. Since then, Azerbaijan began its rapid ascent in terms of GDP, according to EconomyWatch.com, Azerbaijan has the third fastest growing economy in the world as of 2010. This is greatly due to the rapid increase in the extraction of oil and gas.

In the summer of 2006, Investors completed the BTC pipeline which was essential to transporting these massive quantities of oil to international markets as Azerbaijan is a landlocked country. The BTC pipeline runs from Azerbaijan through Georgia to Turkey. This allowed for a large leap in GDP from 2005 to 2006 with a growth rate of 134.5 percent. The trend continued with average GDP growth for the following years exceeding 100 percent according to the Central Bank of Azerbaijan.

According to SperoNews, in an article written in 2008, Economists at the IMF warned the government of Azerbaijan that institutional reform and economic liberalization would be necessary for the country to be able to sustain its future oil wealth. The IMF stated that government spending had increased along with oil revenues. Furthermore they warned that in combination with an accommodating monetary policy, these factors had led to rising inflation, which they stated would have effects on the livelihood of Azerbaijan's population as well as on the state of its non-energy based economy.<sup>38</sup>

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<sup>38</sup> SperoNews. "Azerbaijan energy profile." July 9<sup>th</sup> 2008. <http://www.speroforum.com/a/15709/Azerbaijan-Energy-profile>

### **Chapter 3 – Economic Reasons Behind the Resource Curse:**

This chapter will discuss the economic reasons behind the resource curse and attempt to link these reasons to the economic climate in Azerbaijan. There are four main reasons for the resource curse covered in this chapter, Dutch disease, fluctuations in commodity prices and their effects, underemployment and poverty, and lack of renewability. The aim is to identify whether the leading causes for the resource curse are present in Azerbaijan's economy.

#### **3- 1 - Dutch Disease:**

Dutch Disease was a term coined to describe the economic situation that arose in the 1960's after the Netherlands discovered reserves of natural gas. It is a term often associated to the resource curse and is sometimes used interchangeably. This is incorrect as the phrase "Dutch disease" was originally used to describe a specific economic situation. According to *Professor Paul Steven* of the University of Dundee, it originally referred to the appreciation of the real exchange rate.<sup>39</sup>

This is caused by heavy investment into a specific extractive industry, in this case oil, causing other sectors to suffer from wage and price distress. This eventually leads to the disproportionate growth of non-tradable goods such as construction, transportation and services leading to reduced growth in non-oil industries and especially the agricultural sector.<sup>40</sup>

"Specifically, Dutch Disease theories predict that the wealth that results from uneven investment into the oil sector will appear as higher wages paid in the energy sector (thus attracting workers

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<sup>39</sup> Professor Paul Stevens. Centre for Energy, Petroleum and Mineral Law and Policy, University of Dundee, UK. RESOURCE IMPACT - CURSE OR BLESSING? A LITERATURE SURVEY. 25th March 2003.

<sup>40</sup> Hoffman, David. "Oil and Development in Post-Soviet Azerbaijan," NBR Analysis, vol. 10, no. 3 (August 1999), pp 5-28

from other sectors) and will be spent on non-traded goods, thus leading to a real exchange rate appreciation that reduces the competitiveness of non-energy sectors.”<sup>41</sup>

Considering that increases in exchange rates often entail inflation and rising prices in tradable goods, the local sales and exports decline which leads to reduced competitiveness with imported goods. Over time as exports decrease and imports increase, local production of tradable goods and agricultural goods declines, leading to unemployment and a growing dependence on the oil sector.<sup>42</sup>

According to a paper written by *David I. Hoffman* in 1999, Azerbaijan was already showing a strong susceptibility to “Dutch disease”. *Hoffman* stated that, “Foreign investment in Azerbaijan, which comprises 68 percent of total investment, is overwhelmingly concentrated (74 percent) in the oil sector. Many other preconditions of Dutch Disease are also evident in Azerbaijan, including: the strong dependence on a single natural resource, an evaporating industrial and agricultural base, the preponderance of state ownership in the economy and in total enterprise debt, an autocratic political process with no clear succession mechanism, the concentration of political power in a single individual, and time-inconsistent spending decisions, evincing an inability to articulate a long-term plan for balanced economic development.”<sup>43</sup>

In Figure 1, the composition of GDP in terms of oil related GDP and non-oil related GDP is visible. In 2005, the oil-GDP overtook the non-oil GDP and the correlation between the increase in total GDP and the increase in oil-GDP is highlighted. Azerbaijan is highly dependent on oil exports and judging from figure 1 that dependence is increasing.

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<sup>41</sup> W. Max Corden, “Booming Sector and Dutch Disease Economics: A Survey,” Working Paper 079, Canberra: Australian National University, 1982.

<sup>42</sup> Tsalik, Svetlana of the Caspian Revenue Watch. *Caspian Oil Windfalls: Who will Benefit?* Copyright 2003 by Open Society Institute.

<sup>43</sup> Hoffman, David. “Oil and Development in Post-Soviet Azerbaijan,” *NBR Analysis*, vol. 10, no. 3 (August 1999), pp 5-28



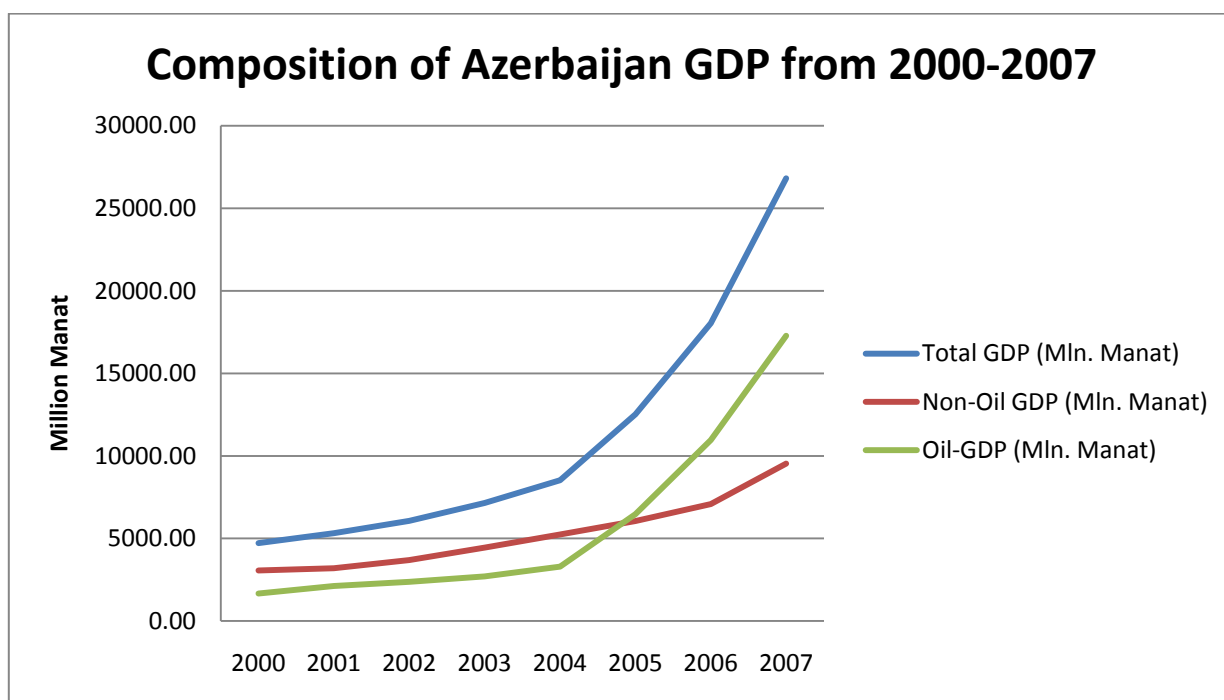


Figure 1.<sup>44</sup> Shows the composition of Azerbaijan's GDP from 2000-2007.

Figure 2, below, shows the exchange rate for the Azerbaijan Manat (AZN) to different currencies in the region from 2000-2009. The exchange rate compared to the US Dollar or the Euro shows a relatively close correlation over the period specified. On the other hand if a comparison is made between the value of the Manat to other currencies in nearby countries like Iran, Turkey, Belarus, Estonia and the Ukraine, it is visible that the Manat is a very high valued currency.

Considering the high value of the Manat in comparison to the currencies of other countries it is possible to deduce that Azerbaijan goods could be relatively non-competitive on the international market when considering goods not related to the extractive industry. Having such a high valued currency is harmful to Azerbaijan's non-oil related exports. This fact is supported by the statistics in Figure 3.

<sup>44</sup> Central Bank of the Republic of Azerbaijan. "Table 1.1 Main Macro-economic Indicators."  
[http://www.cbar.az/assets/92/1.1\\_eng.pdf](http://www.cbar.az/assets/92/1.1_eng.pdf)

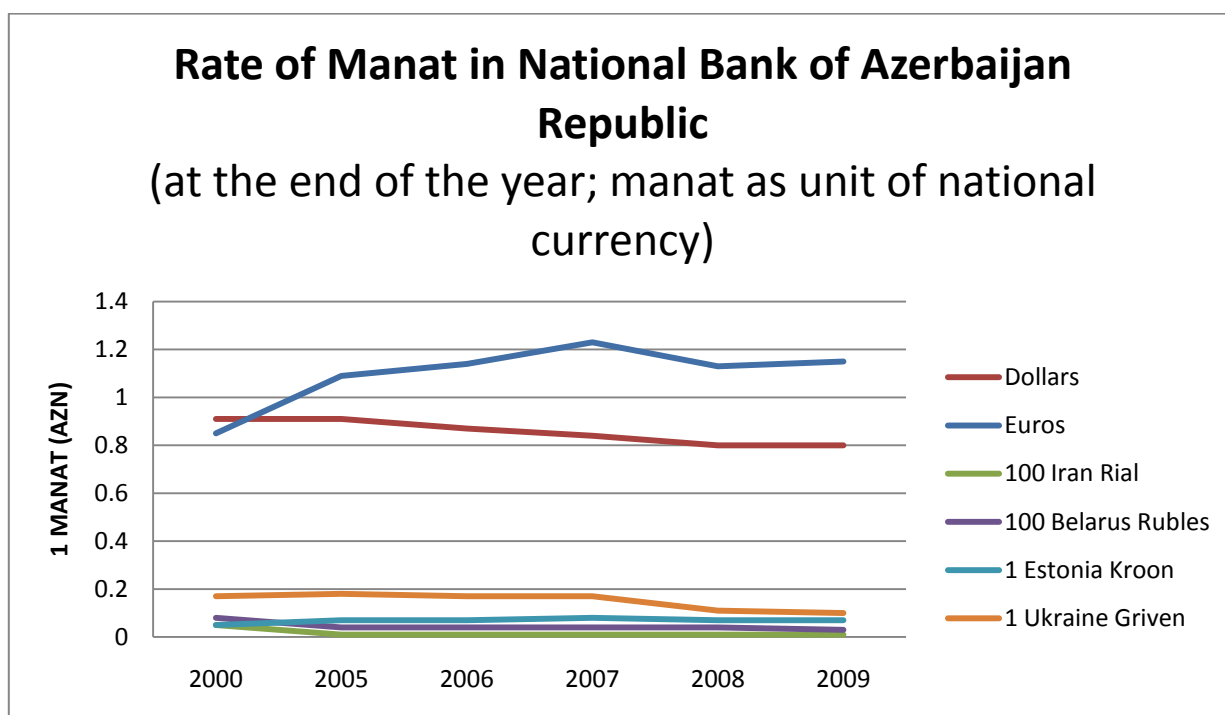


Figure 2. <sup>45</sup> Shows the exchange rate of the Azerbaijan Manat (AZN) from 2000 to 2009.

According to the PFMC, revenues from the oil sector constituted 27 percent of Azerbaijan's GDP in 2004, furthermore taxes paid by the oil sector make up approximately 40 percent of all public budget revenues.<sup>46</sup> This shows a high dependence on a single extractive industry which is one of the major indicators of "Dutch disease."

<sup>45</sup> The State Statistical Committee of the Republic of Azerbaijan. "Rate of manat in National Bank of Azerbaijan Republic". [http://www.azstat.org/~hagigat/azs\\_work/statinfo/finance/en/001.shtml](http://www.azstat.org/~hagigat/azs_work/statinfo/finance/en/001.shtml)

<sup>46</sup> Ibid.

Trade turnover by groups of goods in 2009

Names of groups	Imports, thsd. US\$	%	Exports, thsd. US\$	%
<b>Total</b>	<b>6 119 724.7</b>	<b>100.0</b>	<b>14 698 496.5</b>	<b>100.0</b>
Alive animals	65 725.0	1.1	665.8	0.0
Vegetables a plaiting materials	313 819.2	5.1	226 126.2	1.5
Animals and vegetable fats and oils and their cleavage products	72 446.6	1.2	128 867.5	0.9
Food products, beverages, spirits and vinegar, tobacco	519 606.2	8.5	170 431.2	1.2
Mineral products	171 947.9	2.8	13 644 201.8	92.8
Products of chemical industry	401 747.8	6.6	33 682.2	0.2
Plastic, rubber and articles thereof	169 624.6	2.8	60 783.2	0.4
Raw hides and skins and articles of leather	3 070.4	0.1	7 838.6	0.1
Wood and articles of wood	86 503.1	1.4	942.6	0.0
Paper and paperboard; articles of paper pulp of paper or of paperboard	128 862.1	2.1	2 476.3	0.0
Textile materials	53 180.1	0.9	45 448.0	0.3
Footwear, headwear, umbrellas artificial flower	8 095.3	0.1	159.2	0.0
Articles of stone, cement and ceramic	156 357.6	2.6	1 191.4	0.0
Pearls, precious stones, precious metals; and articles there	21 132.1	0.3	24 949.5	0.2
Miscellaneous articles of base metal	663 282.6	10.8	121 198.9	0.8
Machine, electrical technological equipment	2 128 996.5	34.8	29 599.5	0.2
Vehicle other than railway or tramway rolling stock, ships and air-transport facilities	780 801.6	12.8	171 387.7	1.2
Musical instruments, medical and other equipment	213 439.4	3.5	5 292.4	0.0
Miscellaneous manufactured articles	68 493.5	1.1	6 745.1	0.0
Works of art, collection pieces and antiques	11 998.5	0.2	445.3	0.0

Figure 3.<sup>47</sup> Shows trade turnover by groups of goods in 2009 in Azerbaijan.

As seen in Figure 3, 92.8 percent of exports in 2009 were mineral products. Furthermore, it is visible that the biggest imports were machine, electrical technological equipment.

Figure 4 shows that the percentage of the industrial sector representing extractive industry has grown steadily over the time period specified. Furthermore, the percentage representing the manufacturing industry has decreased.

<sup>47</sup> The State Statistical Committee of the Republic of Azerbaijan. "Trade Turnover by Groups of Goods in 2009." <http://www.azstat.org/publications/azfigures/2010/en/018.shtml>

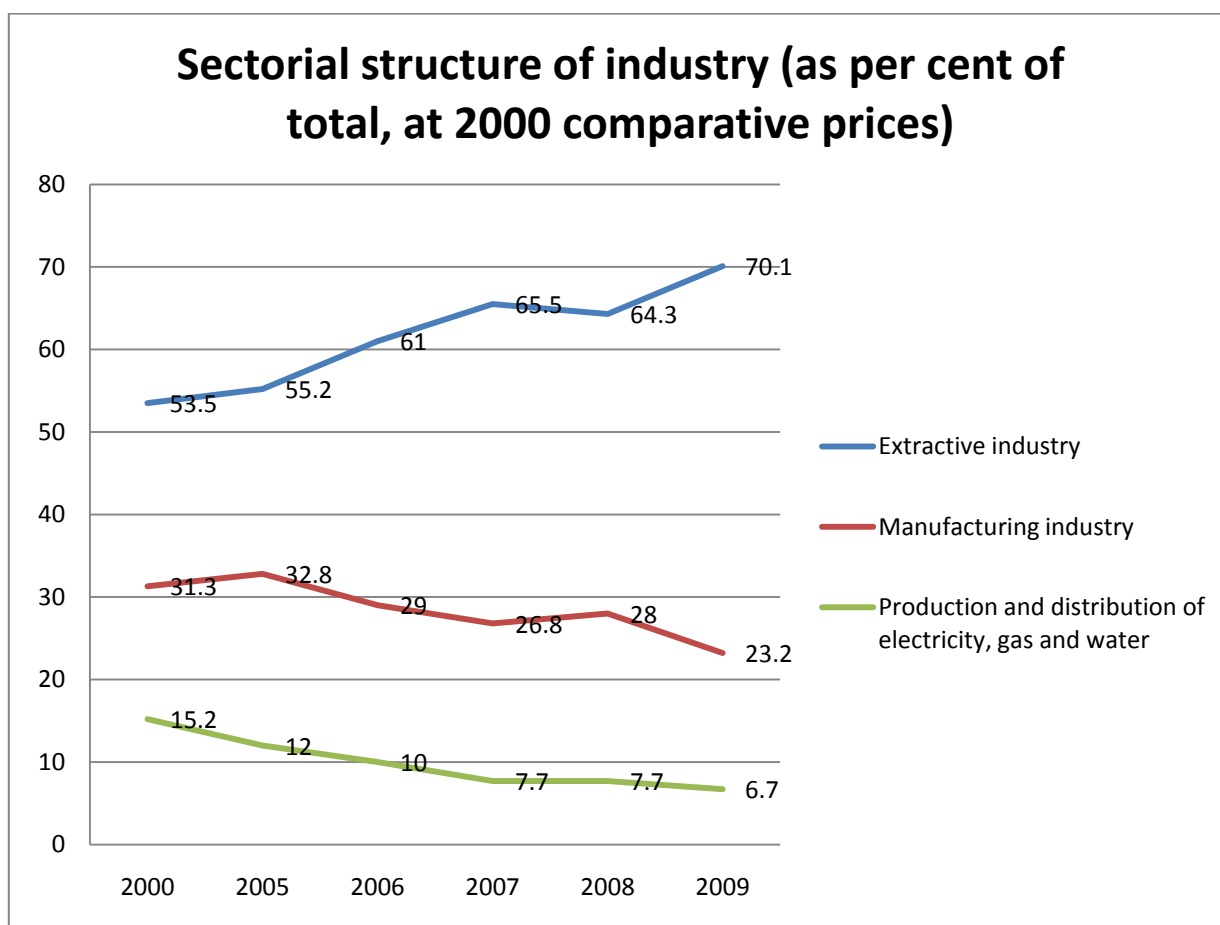


Figure 4.<sup>48</sup> Shows the Sectorial Structure of Industry in Azerbaijan as a percentage of the total over the period of 2000-2009.

On the other hand, Figure 5. shows that the volume of industrial products from the manufacturing industry has increased over the time period specified. The volume of industrial products from the extractive industry has increased at a higher rate thus producing the percentages in Figure 4.

<sup>48</sup> Ibid.

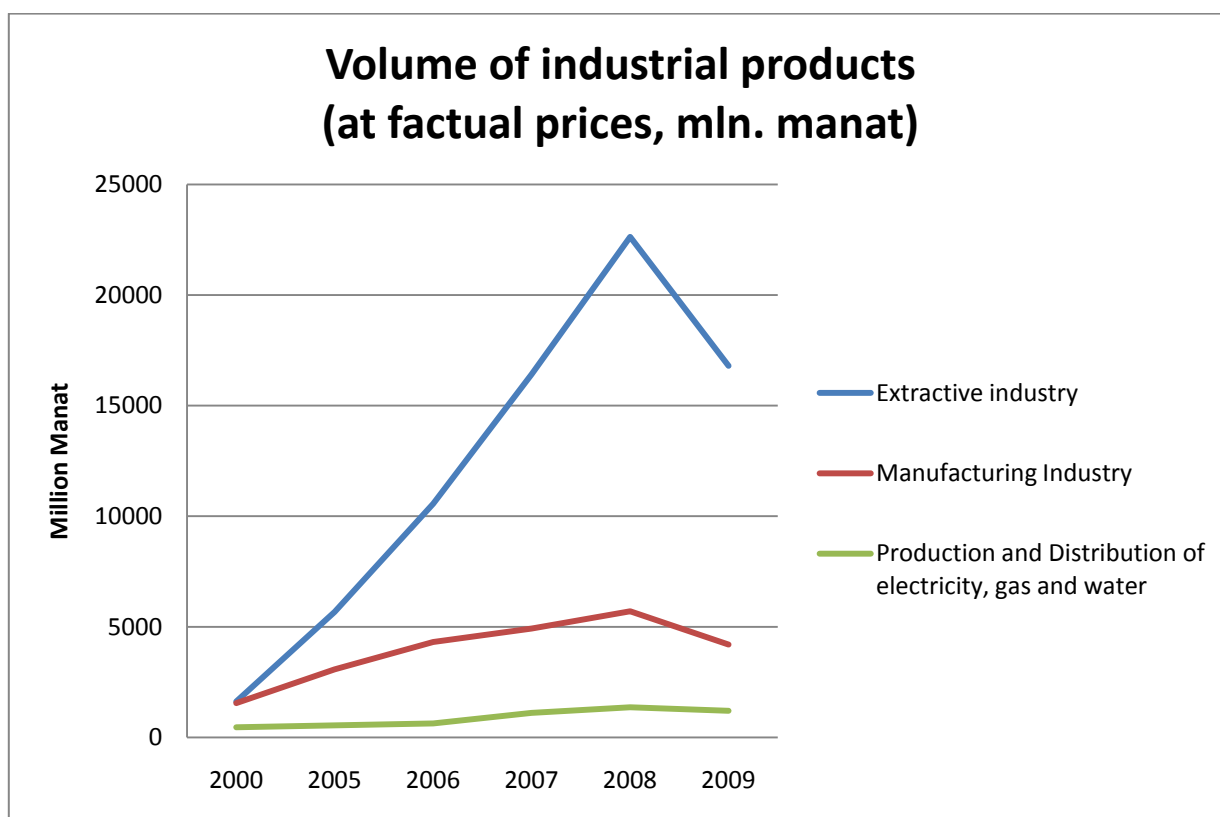


Figure 5.<sup>49</sup> Shows the Volume of industrial products produced by different sectors of the economy from 2000-2009.

Furthermore it is visible in Figure 5 that there was a sudden decrease in the volume of industrial products originating from the extractive industry from 2008 to 2009. Oil prices boomed in 2008 reaching record highs of over 120 US dollars per barrel, and a contractual shift in the profit-sharing ratio of the oil consortium in favor of the government also occurred in 2008. The decrease in the volume of extractive industry products may have been a move made by officials to adapt the level of supply to falling demand due to heavily inflated oil prices.

Despite the percentages in Figure 4, the volume of industrial products produced by the manufacturing sector is increasing. According to Figure 3, the increases are not visible in exports, so one can deduce that these increases are being consumed locally rather than being exported to other countries. This shows that exports are not doing well, which may be due to the lack of competitiveness of Azerbaijan's industrial products on international markets (Chapter 3).

<sup>49</sup> Ibid.

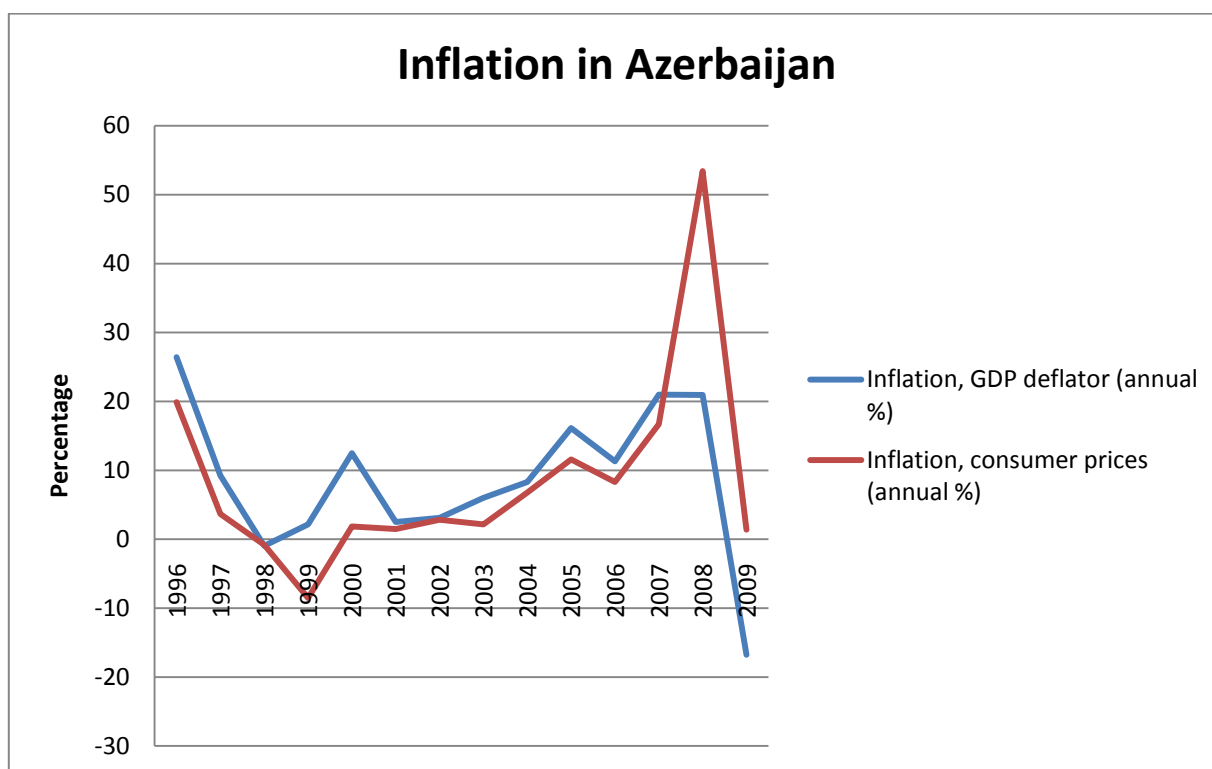


Figure 6.<sup>50</sup> Shows inflation in terms of GDP deflator and consumer prices in Azerbaijan from 1996 to 2009.

According to the World Bank, *inflation, GDP deflator* is “inflation as measured by the annual growth rate of the GDP implicit deflator shows the rate of price change in the economy as a whole. The GDP implicit deflator is the ratio of GDP in current local currency to GDP in constant local currency.” Furthermore, *inflation, consumer prices* is “inflation as measured by the consumer price index reflects the annual percentage change in the cost to the average consumer of acquiring a basket of goods and services that may be fixed or changed at specified intervals, such as yearly. The Laspeyres formula is generally used.”<sup>51</sup>

Figure 6. shows us that inflation dropped from 1996 to around 1999 but then began to rise again until peaking in 2008 and since then it appears to be on the decline. However Figure 7. shows that average annual inflation began to rise again up to October 2010 reaching over 5 percent.

<sup>50</sup> World Bank. “Azerbaijan country data.” <http://data.worldbank.org/country/azerbaijan>

<sup>51</sup> Ibid.

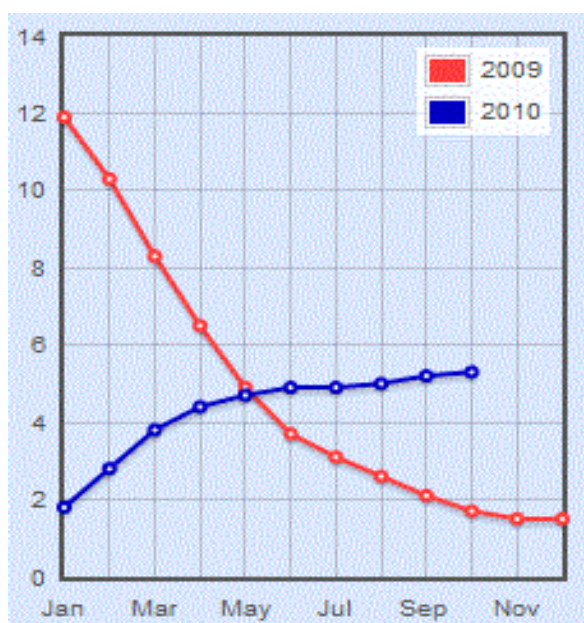


Figure 7.<sup>52</sup> Shows average annual inflation for 2009 to October 2010.

There are many schools of thought on the causes of inflation in an economy, in the case of Azerbaijan though, it is believed, by the IMF that inflation is caused by the massive revenues from oil and gas exports. A certain amount of inflation is inevitable in an economy but high inflation leads to lower purchasing power, especially among the poorer ranks of society. Another by product is the increase in value of the local currency, as is the case for the Azerbaijan Manat. This leads to reduced competitiveness of goods on the international market, thus shrinking the tradable sectors of the economy.

The IMF warns of another inflation led problem which may affect the economy of Azerbaijan. According to a report in September 2006, “the rapidly expanding economy of oil-rich Azerbaijan risks increased inflation if government spending is not reined in. The economy is booming to the point that it is overheating,” IMF Senior Economist Vitali Kramarenko said.”<sup>53</sup>

According to Investopedia, an economics dictionary, overheating of the economy occurs when, “a prolonged period of good economic growth and activity causes high levels of inflation and inefficient supply allocations as producers overproduce and create excess production capacity in

<sup>52</sup> Central Bank of the Republic of Azerbaijan. <http://www.cbar.az/>

<sup>53</sup> BakuTODAY.net. “Oil Boom Overheatinf Azerbaijani Economy: IMF.” September 7<sup>th</sup> 2006. <http://www.bakutoday.net/oil-boom-overheating-azerbaijani-economy-imf.html>

an attempt to capitalize on the high levels of wealth. Unfortunately, these inefficiencies and inflation will eventually hinder the economy's growth and cause a recession.”<sup>54</sup>

Furthermore, “Economists warn that Azerbaijan is showing early signs of the so-called Dutch Disease in which a natural-resources-rich economy sees an increasingly strong local currency and shrinking manufacturing sector.”<sup>55</sup>

According to the World Bank, there are two arguments against the Dutch Disease case. “First, Azerbaijan’s non-oil trading partners also suffered from currency appreciation.” It states that, “the REER for non-oil exports appreciated modestly in 2006-07, and is at the 2002 level.”<sup>56</sup>

The Second argument concerns the rate at which Azerbaijan has been “importing” its foreign currency. According the World Bank, “it has generally been considered sustainable in that it is roughly on par with the permanent income equivalent. Should oil prices stay low, Azerbaijan will have to adjust downwards the level of its oil spending permanently, then a case might be made for Dutch disease should the economy not adjust.”<sup>57</sup>

These arguments are fair, but considering the trends seen in this chapter and in following chapters, it is clear that despite these arguments, inflation is high, strong dominance of the extractive industry is visible, and non-oil related exports are low and these factors can be partially attributed to the effects of Dutch disease.

### **3 - 2 - Fluctuations in Commodity Prices and their Effects:**

Countries that are highly dependent on mineral resources, such as oil, are highly susceptible to fluctuations in global prices for those commodities. The biggest challenge that comes from these so called price shocks is medium and long term budgeting. Sudden, wide fluctuations in global

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<sup>54</sup> Investopedia. “Overheated Economy.”

<sup>55</sup> BakuTODAY.net. “Oil Boom Overheating Azerbaijani Economy: IMF.” September 7<sup>th</sup> 2006.  
<http://www.bakutoday.net/oil-boom-overheating-azerbaijani-economy-imf.html>

<sup>56</sup> World Bank. “Azerbaijan Country Economic Memorandum. A new Silk Road: Export led diversification.” Report No. 44365-AZ. December 23<sup>rd</sup> 2009.

<sup>57</sup> Ibid.



market prices can lead to a windfall for the country or if prices drop it can lead to economic shock, unexpected budget cuts, and there can be negative effects on economic stability.<sup>58</sup>

According to the State Statistical Committee of the Republic of Azerbaijan, 92.8 percent of Azerbaijan's exports in 2009 consisted of mineral products. Furthermore, the extractive industry accounted for 70.1 percent of the industrial sector in the same year.<sup>59</sup> In December of 2010, oil related GDP in Azerbaijan was 57.7 percent of the total GDP for the same time period.<sup>60</sup>

From these statistics it is visible that Azerbaijan is highly dependent on oil and gas revenues and fluctuations in these prices on the global market can have severe consequences. The prices for gas are mostly based on contracts and are less likely to fluctuate as is the case for oil prices. Considering that resources like diamonds are less volatile and susceptible to manipulation to ensure high prices, countries like Botswana that have been proven to successfully mitigate their resource curse, might have had more ease to do so than oil-rich countries.

When oil prices boomed in 2008, reaching record highs of over \$120/bbl., Azerbaijan saw record high GDP, with 40137.2 million AZN in December 2008. In January 2009, GDP fell to 1860 million AZN.<sup>61</sup> Price variations like these can have very bad effects on the economy. For example, in December of 2008, budget revenues were at 10762 million AZN which fell to 997.4 million AZN in January of 2009, a 90.73 percent drop in budget revenues in one month. Budget expenditures also fluctuate with oil price variations, from December 2008 to January 2009, budget expenditures also dropped a dramatic 97.7 percent.<sup>62</sup>

Budgeting which is done when prices of commodities are high and income is abundant can be affected by economic shock if prices fluctuate unexpectedly. Many countries turn to borrowing as is the case for Saudi Arabia which is rich in oil resources. "...a review of the Saudi economy by the International Monetary Fund indicates that, with the exception of the year 2000, in which

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<sup>58</sup> Jim Shultz. OSI. Following the Money: A Guide to Monitoring Budgets and Oil and Gas Revenues. Page 36. November 17 2004.

<sup>59</sup> The State Statistical Committee of the Republic of Azerbaijan. "Trade Turnover by Groups of Goods in 2009." <http://www.azstat.org/publications/azfigures/2010/en/018.shtml>

<sup>60</sup> The Central Bank of the Republic of Azerbaijan, The State Committee on Statistics of the Republic of Azerbaijan. [http://www.cbar.az/assets/92/1.1\\_eng.pdf](http://www.cbar.az/assets/92/1.1_eng.pdf)

<sup>61</sup> Ibid.

<sup>62</sup> Ibid.

the overall central government budget registered a sharp turnaround due largely to a rise in oil prices, "in every other year, the budget has run a deficit and the debt stock has run up to \$170 billion, which is equal to the size of GDP."<sup>63</sup> (By comparison, in the European Union, the ratio of public debt to GDP is restricted to 60 percent.)"<sup>64</sup> This means that due the volatility of oil prices, Saudi Arabia was forced to borrow large amounts of money to cover spending when forecasted revenues did not meet real revenues.

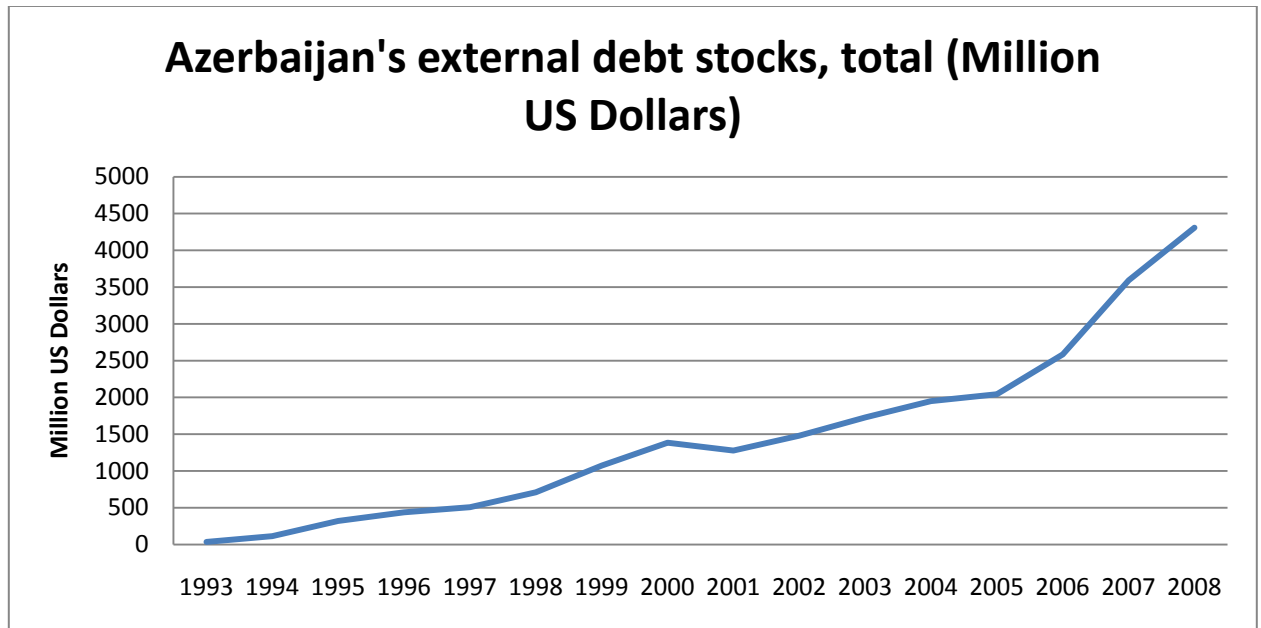


Figure 8.<sup>65</sup> Shows Azerbaijan's Debt from 1993 to 2008.

As Figure 8 shows, in 2008, external debt reached 4.3 billion US Dollars (9.3 percent of GDP in 2008). External debt more than doubled from 2005 to 2008. Figure 8 shows that the accumulation of external debt has shown no sign of slowing.

If the trend continues, external debt could rise swiftly in coming years. Considering that the current oil and gas reserves of Azerbaijan are forecasted to last about 20 years, the massive accumulation of external debt could have a significant negative effect on the economy after production runs dry.

<sup>63</sup> "Article IV Consultation with Saudi Arabia." International Monetary Fund. November 7, 2001.

<sup>64</sup> MERIA (Middle East Review of International Affairs). "SAUDI ARABIA: A BRIEF GUIDE TO ITS POLITICS AND PROBLEMS." Volume 7, No. 3 - September 2003.

<sup>65</sup> World Bank. "Azerbaijan country data." <http://data.worldbank.org/country/azerbaijan>

The effects of price shocks are visible in the economy of Azerbaijan due to its high dependence on its extractive industry. To help mitigate these effects, other sectors of the economy must be developed in an effort to cushion the effects of price shocks. This will help Azerbaijan escape the resource curse.

### **3 – 3 - Underemployment and Poverty:**

Figure 9 shows the two main sectors of employment are Agriculture, hunting and forestry (38%) and Wholesale and retail trade, repair of motor vehicles, personal and household goods (16%). Prior to its Independence, Azerbaijan's industrial focus was based on the inheritance from the Soviet Union with the main sectors being the production of aluminum ore, crude oil, and a number of processed foods and high-value agricultural products.

According to the World Bank, the revenues from the agricultural sector have grown consistently at an average of about 5 percent a year, and despite fluctuations, the industrial sector has achieved average growth in revenues of 10 percent per year for most years. Many transition economies see growth in the service sector, this is also the case for Azerbaijan that saw consistent growth of about 10 percent in the service sector per year.<sup>66</sup>

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<sup>66</sup> World Bank. "Azerbaijan Country Economic Memorandum. A new Silk Road: Export led diversification." Report No. 44365-AZ. December 23<sup>rd</sup> 2009.

### Distribution of employed population by activity 2009 (Percentage)

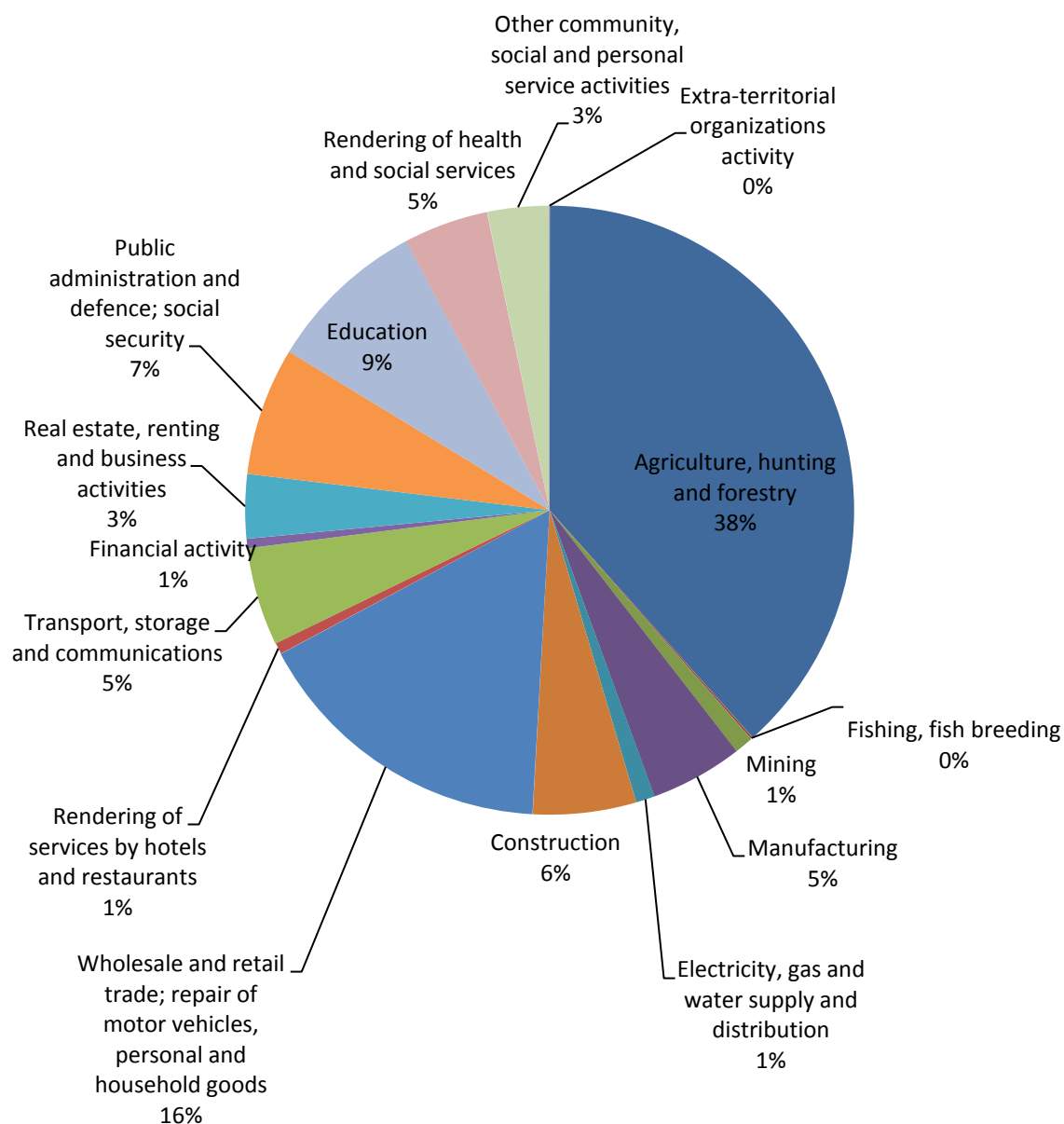


Figure 9.<sup>67</sup> Shows the distribution of Employed population by activity in 2009. (Percentage).

<sup>67</sup> The State Statistical Committee of The Republic of Azerbaijan. "Distribution of Employed Population by Activity." 2009. [http://www.azstat.org/statinfo/labour/en/002\\_1.shtml](http://www.azstat.org/statinfo/labour/en/002_1.shtml)

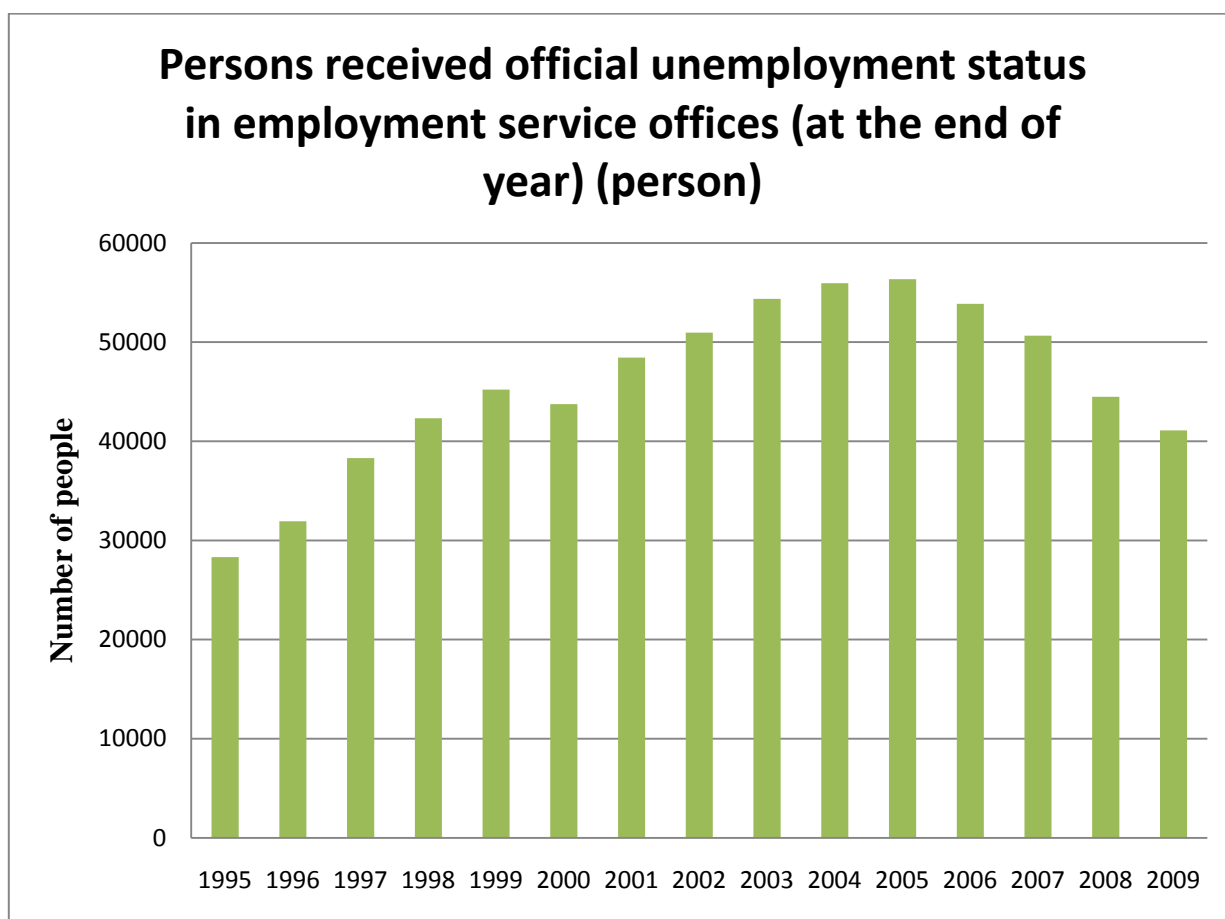


Figure 10.<sup>68</sup> Show the Number of people that received official Unemployment status in the employment service offices at the end of each year for the period of 1995-2009.

Figure 10 shows that official unemployment statistics, obtained from the State Statistical Committee of the Republic of Azerbaijan, peaked in 2005 and have been on the decline ever since. Considering the fact that these are official statistics showing only the numbers for people who registered with the employment service offices, it is safe to assume that these numbers differ due to non-registered workers.

According to the World Bank, formal employment in Azerbaijan increased approximately 13 percent from 1995-2008, with approximately 80 percent of the growth occurring since 2000.<sup>69</sup>

<sup>68</sup> State Statistical Committee of the Republic of Azerbaijan. "Persons received official unemployment status in employment service offices (at the end of year) (person)." <http://www.azstat.org/indexen.php>

<sup>69</sup> World Bank. "Azerbaijan Country Economic Memorandum. A new Silk Road: Export led diversification." Report No. 44365-AZ. December 23<sup>rd</sup> 2009.

It is important for the government to promote investment in the primary sectors of employment in Azerbaijan as there is a real risk that the labor force may shift from these industries towards non-tradable industries such as construction in search of better financial prospects. This would further slow the growth in the primary industries such as agriculture (which employs the largest portion of the labor force) leading to stronger negative effects related to the resource curse on the economy.

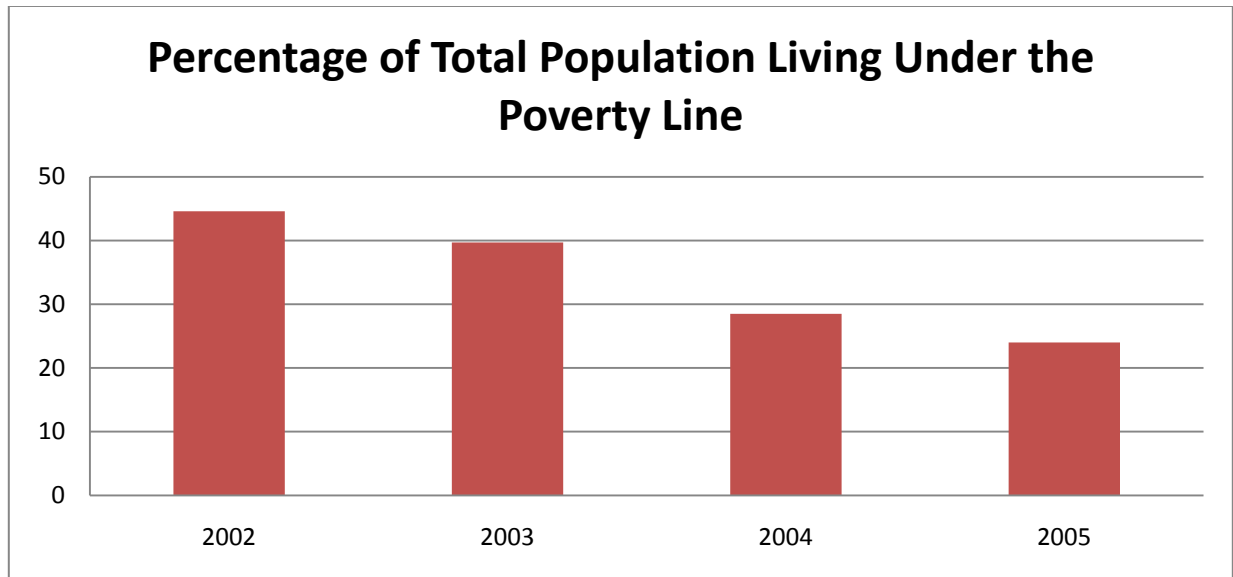


Figure 11.<sup>70</sup> Shows the percentage of the total population living under the poverty line in Azerbaijan from 2002-2005. Poverty line as defined by the State Statistical Society of the Republic of Azerbaijan.

It is visible from Figure 11 that the percentage of the total population living under the poverty line in Azerbaijan has been consistently decreasing since 2002. A close to 50 percent drop in poverty is visible in the four year period observed. Furthermore, the government estimates that the poverty level fell further to 16.9 percent in 2006.<sup>71</sup>

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<sup>70</sup> Ibid.

<sup>71</sup> Ibid.

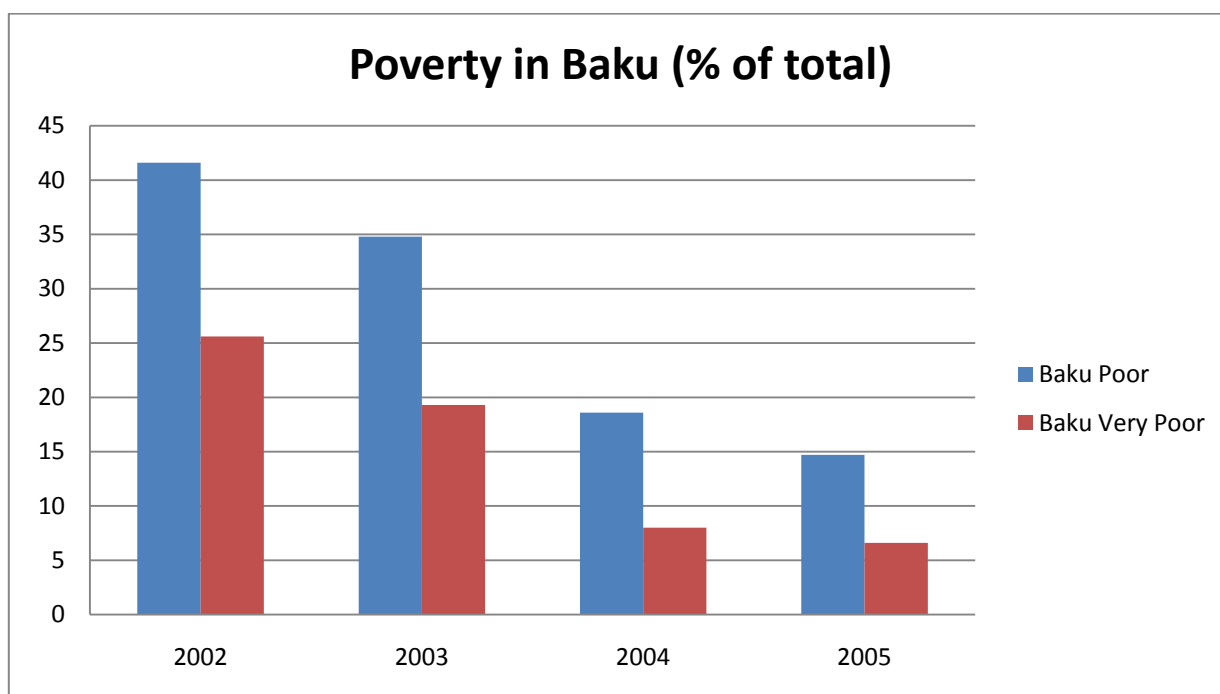


Figure 12.<sup>72</sup> Shows the percentage of the total population living under the poverty line in the region of Baku, the Country's capital, in terms of poor and very poor.

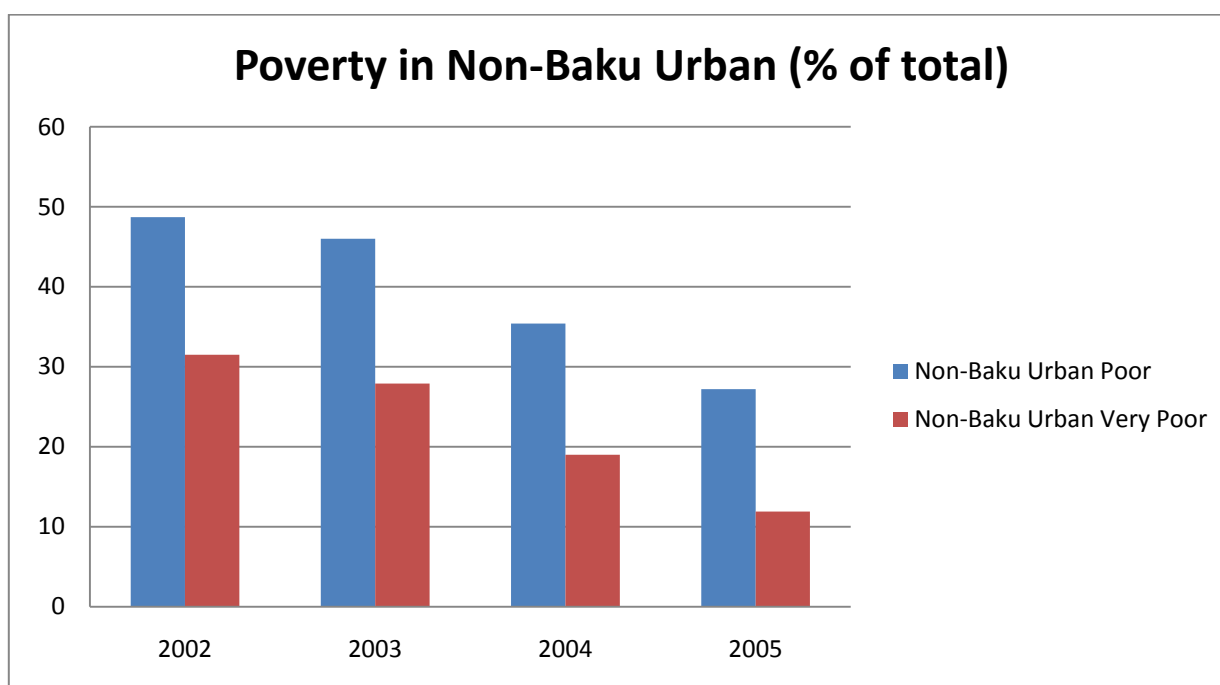


Figure 13.<sup>73</sup> Shows the percentage of the total population living under the poverty line in the non-Baku urban regions, in terms of poor and very poor.

<sup>72</sup> Ibid.

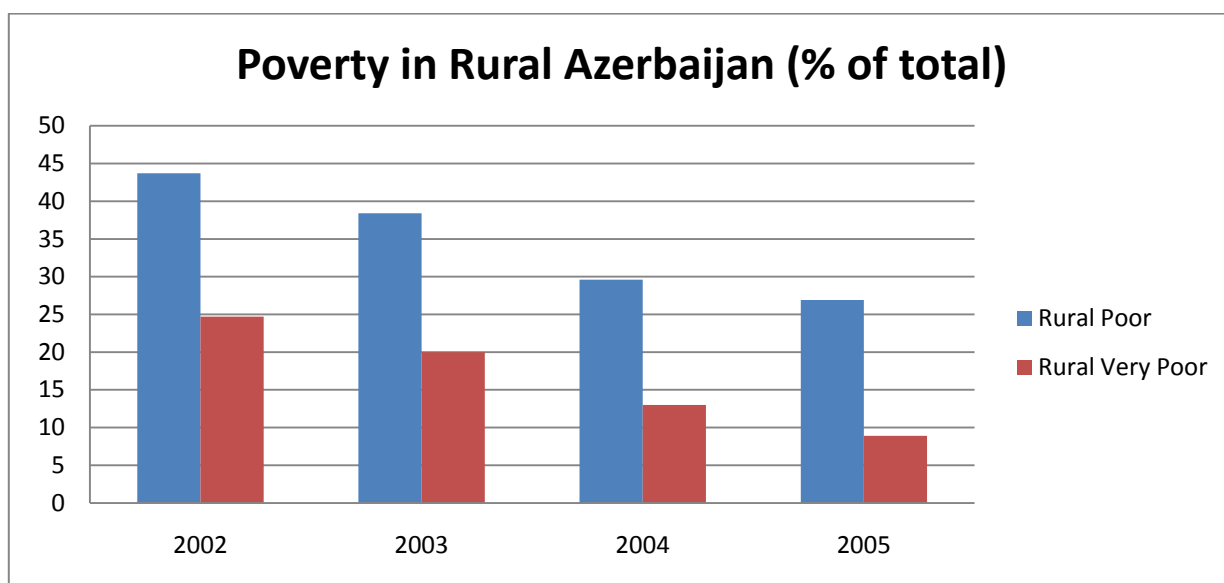


Figure 14.<sup>74</sup> Shows the percentage of the total population living under the poverty line in the urban regions, in terms of poor and very poor.

Figures 12, 13 and 14, show that the concentration of poverty is outside Baku, the country's capital city. Urban areas outside the capital suffer higher levels of poverty and extreme poverty than the Capital and rural areas are closely related to non-Baku urban areas. Generally though, there is a visible decrease in poverty across all the strata of Azerbaijan's society.<sup>75</sup>

These figures show that the government must concentrate its efforts to alleviate poverty on rural areas especially but also to continue its efforts in urban areas. Education is a key issue which must be addressed in rural areas and employment opportunities must be developed with regard to the level and focus of new education initiatives.<sup>76</sup>

<sup>73</sup> Ibid.

<sup>74</sup> Ibid.

<sup>75</sup> Ibid.

<sup>76</sup> Ibid.



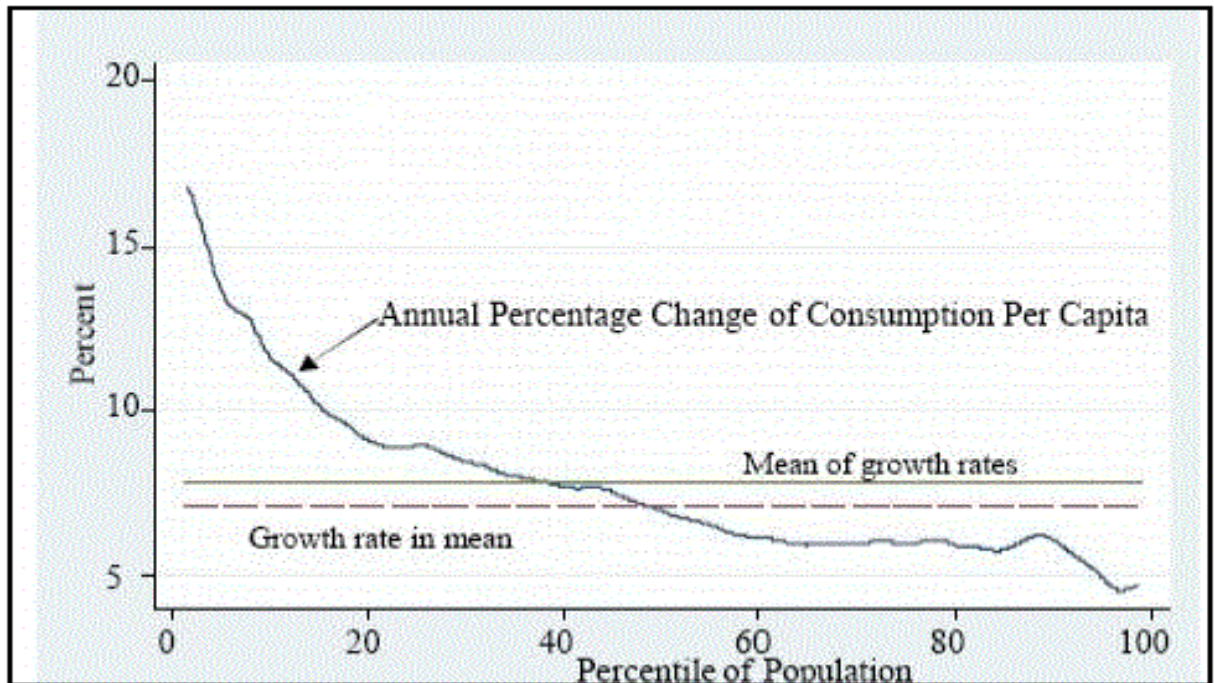


Figure 15.<sup>77</sup> Shows the Azerbaijan Growth incidence curve for 2002-2005. This curve shows the growth in consumption according to different percentiles of the Azeri population.

Figure 15 shows that the annual percentage change of consumption per capita was higher for the lower deciles of the population than for the higher deciles. This shows that growth was pro-poor over this period.<sup>78</sup>

Despite these promising figures, the rate of poverty in rural areas remains almost twice as high as in the country's capital.<sup>79</sup> "Lack of employment, assets, and commercial opportunities, as well as weaker access to basic infrastructure, health, and educational services have been major factors keeping poverty relatively high in provincial towns and rural areas. Refugees and internally displaced people are particularly vulnerable because they not only lack assets and employment but also are heavily dependent on state transfers."<sup>80</sup>

<sup>77</sup> Ibid.

<sup>78</sup> Ibid.

<sup>79</sup> Ibid.

<sup>80</sup> Ibid.

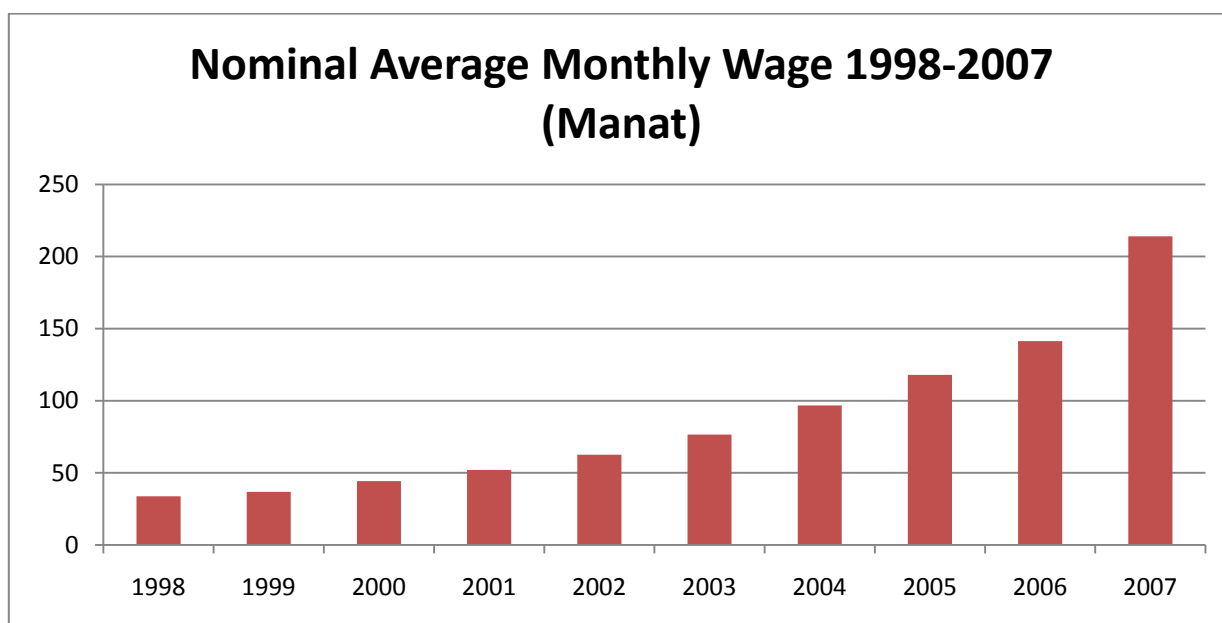


Figure 16.<sup>81</sup> Shows the nominal average monthly wage in Azerbaijan from 1998-2007.

As Figure 16 shows, the nominal average monthly wage has increased consistently from 1998, where it was at 33.7 Manat, to 2007 where it was at 214 Manat. This is only one of the factors leading to the reduction of poverty in Azerbaijan. Other factors include a higher minimum wage, significant transfers to households based on government social programs and remittances from abroad, especially from Azerbaijan nationals living in Russia.<sup>82</sup>

In December of 2009, the minimum wage in Azerbaijan was at 75 Manat. Between the period of 2001-2008, the government increased the extremely low minimum wage six-fold. According to the World Bank, wages and salaries on average, tripled in real terms since 2000. After 2005, the government engaged in an expansive fiscal policy which contributed to these increases.<sup>83</sup>

The basic pension of 14 Manat per month in January 2002 increased to 75 Manat per month in September 2008. Pensions were the main factor of the government's social program. (Considering that inflation rates in consumer prices (Figure 6.) were increasing throughout this period and peaked at over 50 percent in 2008, the actual increases in pensioners consumption

<sup>81</sup> Central Bank of the Republic of Azerbaijan. "Table 1.1 Main Macro-economic Indicators." [http://www.cbar.az/assets/92/1.1\\_eng.pdf](http://www.cbar.az/assets/92/1.1_eng.pdf)

<sup>82</sup> World Bank. "Azerbaijan Country Economic Memorandum. A new Silk Road: Export led diversification." Report No. 44365-AZ. December 23<sup>rd</sup> 2009.

<sup>83</sup> Ibid.

capabilities may have been severely affected by inflation in consumer prices.) Furthermore, remittances from Azerbaijan national living and working abroad reached \$ 1.2 billion in 2008, a 10 fold escalation in nominal dollar terms since 2001.<sup>84</sup>

Overall it seems that Azerbaijan has made big steps in the fight against unemployment and poverty, though these figures still remain relatively high in rural areas. A concentration of investment should be directed at the primary sectors of the economy, industrial and agricultural to ensure continued development. Diversification is key to reducing dependency on resource based revenues as well as reducing unemployment and poverty. Furthermore it is important to consider education as another essential factor in these efforts.

### **3 - 4 - Limitations of Oil and Gas resources:**

It is a well-established fact that fossil fuels and minerals are developed over millions of years due to the pressure and heat underground, meaning these resources are finite. Countries like Azerbaijan must look beyond the temporary revenues achievable through the extraction of their natural resources and use those revenues to ensure sustainable economic growth when the resources run out.

In the case of Azerbaijan, oil extraction has been said to date back to the 10<sup>th</sup> century AD.<sup>85</sup> It is understandable that today Azerbaijan has developed a strong dependence on the oil and gas industry. In 2009, according to the State Statistical Committee of the Republic of Azerbaijan, 92.8 percent of exports were oil-related. In Figure 17, it is visible that Azerbaijan's industrial sector is dominated by oil related industry.

On April 1<sup>st</sup> of 2009, Azerbaijan's fuel oil reserves amounted to 339,000 tons according to an Azerbaijan news agency.<sup>86</sup> Furthermore, according to the EIA, Azerbaijan's proven oil reserves totaled 7 Billion bbl and natural gas reserves totaled 30 trillion cubic feet (Tcf) in January

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<sup>84</sup> Ibid.

<sup>85</sup> Huseynov. "Oil Policy and Strategy of Azerbaijan". Caspian Region Workshop. Applicability of Norway's socio-economic and political strategy as Oil-State for the Caspian Region. 2-3 February 2006, Berlin.

<sup>86</sup> Rufat Abbasov. "Fuel oil reserves in Azerbaijan make up 338,100 tons." News.AZ. 24<sup>th</sup> of April 2010. <http://www.news.az/articles/14135>

2009.<sup>87</sup> According to Svetlana Tsalik of the Open Society Institute's Revenue Watch Program, production of oil is expected to taper off in the next 20 years if no new reserves are found.<sup>88</sup>

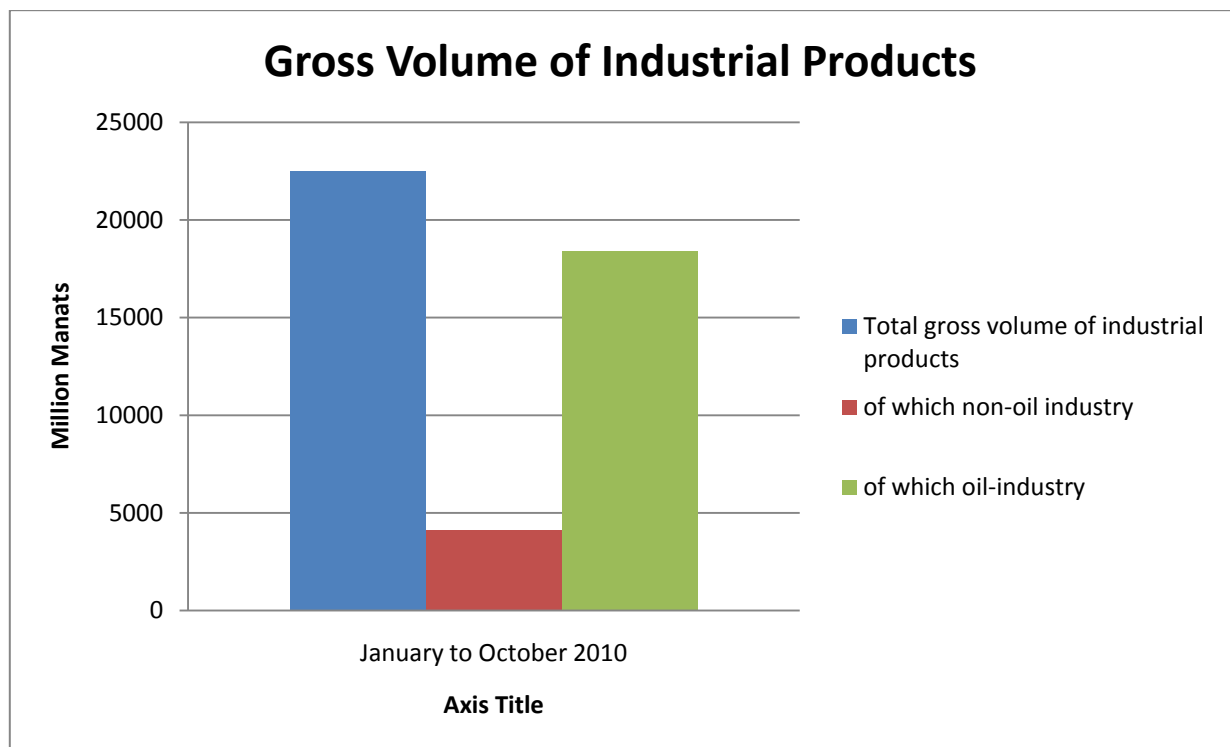


Figure 17.<sup>89</sup> Shows the gross volume of industrial products produced in Azerbaijan from January to October of 2010.

Figure 17 shows that the bulk of products produced by Azerbaijan Industry are related to oil. Considering that oil and gas are non-renewable products and that experts like Svetlana Tsalik believe that the current reserves of Azerbaijan will not last longer than 20 more years, it is essential that the government encourage the shift of industrial products towards non-oil related industry. The key to this is investment and diversification among other possible strategies.

One good example of forward thinking on the part of Azerbaijan is the BTK (Baku-Tbilisi-Kars) railway project which will run from Azerbaijan, through Georgia and into Turkey. This rail project is a step forward in diversification for Azerbaijan as it will join the West (Europe) with

<sup>87</sup> EIA. "Azerbaijan: Oil." <http://www.eia.doe.gov/cabs/Azerbaijan/Oil.html>

<sup>88</sup> Svetlana Tsalik, of the Caspian Revenue Watch. Caspian Oil Windfalls: Who will Benefit? Copyright 2003 by Open Society Institute.

<sup>89</sup> State Statistical Committee of the Republic of Azerbaijan. External Economic Activities: Exports by group. <http://www.azstat.org/MESearch/details>

the East (Asia) turning Baku into a transportation hub. This project is often referred to as the silk-road, as it will serve as a trade passage along the ancient Silk Road which allowed trade between East and West. The total cost of the project is estimated at 600 million US dollars and is expected to be completed in 2012.<sup>90</sup>

Projects such as this are very important for Azerbaijan and may lead to more opportunities in the future as they attract foreign direct investment (FDI) as well as providing employment.

In light of limited oil and gas reserves, it is important to use the current revenues to establish sustainable industry in Azerbaijan. The government must decide where the country wants to be in 20 years, after their resources begin to dwindle, how they want to get there, and how they will go on from that point.

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<sup>90</sup> Railway-Technology.com. "Baku, Tbilisi, Kars line, International." <http://www.railway-technology.com/projects/baku-tbilisi-kars/>

## **Chapter 4 - Economic Symptoms of the Resource Curse in Azerbaijan:**

This chapter focuses on the economic symptoms of the resource curse and attempts to identify whether these symptoms are visible in Azerbaijan's economy. It consists of five parts, loss of competition, deindustrialization in non-oil sectors (symptom of Dutch disease), tradable vs. non-tradable goods, non-efficient government spending, and the shrinking agricultural sector.

### **4 -1 - Loss of Competition**

The loss of competition in local and global markets is a common effect of the resource curse. Dutch disease leads to the appreciation of the currency, which in turn pushes up the prices of exports and local goods. It becomes cheaper for trade partners to import goods from alternative countries and it also becomes cheaper for local retailers to import and sell goods on the local market which originate from foreign countries.

Figure 18 shows the geographical structure of external trade relations in 2009 in Azerbaijan. The important thing to underline is that for 2009, 92.8 percent of exports were related to oil (Figure 3), which tells us that the balance of trade in non-oil related products is very much in favor of imports. Total trade turnover for 2009 was 20818.2 Million Us dollars, imports totaled 6119.7 Million US dollars, and exports totaled 14698.5 Million US dollars.<sup>91</sup>

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<sup>91</sup> Ibid.

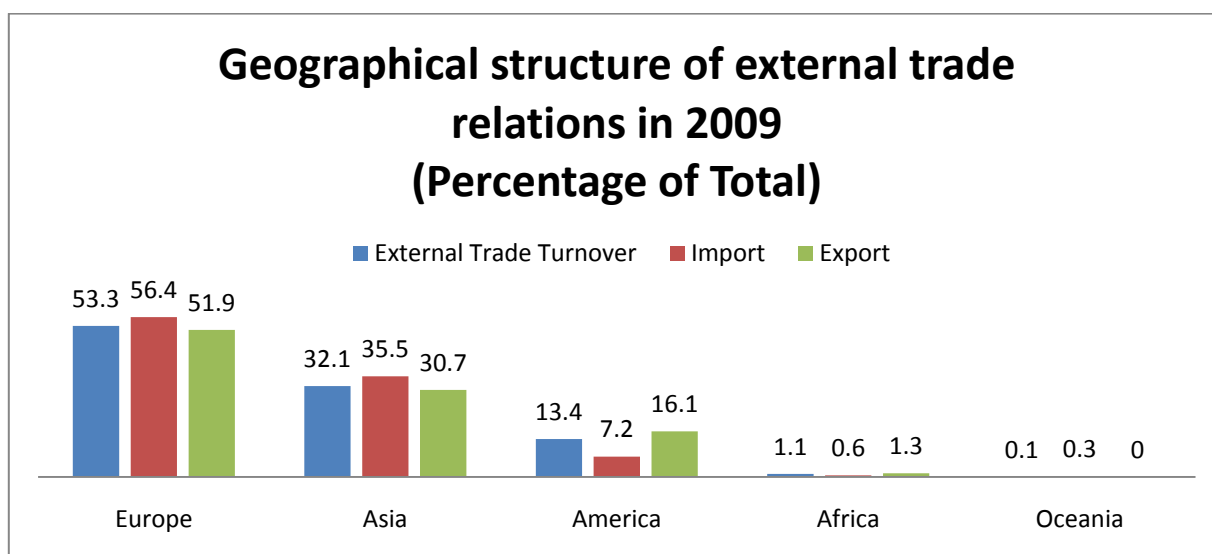


Figure 18.<sup>92</sup> Shows the geographical structure of external trade relations in 2009 as a percentage of the total.

The main trading partners on the EU are Italy (also the largest overall trading partner with a trade turnover of just under 4 billion US dollars in 2009), France and Germany. The US is Azerbaijan's second biggest trading partner. In Asia Russia is its biggest trading partner followed by Turkey.

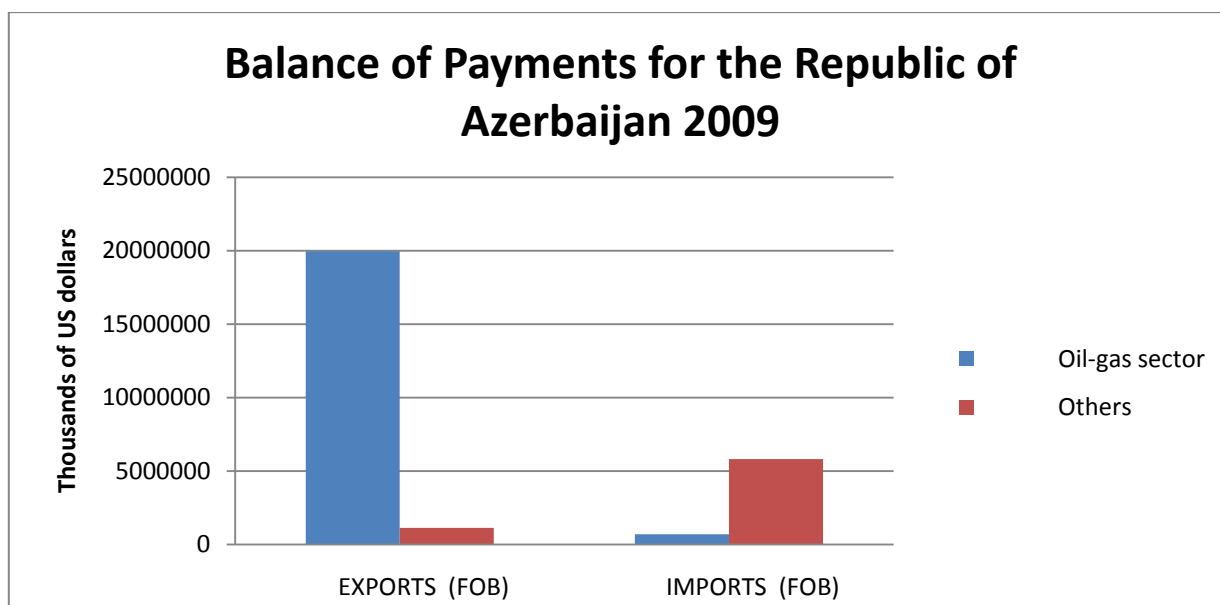


Figure 19.<sup>93</sup> Shows the Balance of Payments for the Republic of Azerbaijan for the year 2009.

<sup>92</sup> Ibid.

Figure 19 shows that Azerbaijan oil-exports in 2009 surpassed 20 billion US dollars while exports from the non-oil sectors of the economy consisted of just over 1 billion US dollars. On the other hand non-oil related imports totaled just under 6 billion US dollars. Revenues from oil exports are 20 times higher than revenues from non-oil exports.

If Azerbaijan had stopped exporting oil in 2009, the revenues from exports would have been only 4.76 percent of what they were. This would have had catastrophic economic effects on the economy. The lack of non-oil exports shows the weakness of the non-oil based economy and the urgent need for development in the non-oil sector.

One certain way to promote competition is by investing in local economy. Figure 20 shows levels of investment from 2000-2009, both internal investment and foreign investment. It is visible that most foreign investment is made in the oil industry. The rest of foreign investment is made in the form of credit. It is clear that the majority of foreign investment in Azerbaijan is directed at the oil industry. It would be highly beneficial to the local economy to receive investments on other sectors.

Also visible in Figure 20 is a significant decline in internal and foreign investment in the economy. This fall in investment coincides with the drop in the volume of products produced by the extractive industry in the same year (Figure 5). The boom in oil prices may have led to an excess in demand in the oil industry thus forcing officials to reduce supply to compensate. Furthermore in 2008, a contractual shift in the profit-sharing ratio of the oil consortium in favor of the government also occurred. This may have affected the level of foreign investment.

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<sup>93</sup> Central Bank of the Republic of Azerbaijan. "Table 1.1 Main Macro-economic Indicators."  
<http://www.cbar.az/pages/statistics/external-sector-statistics/>



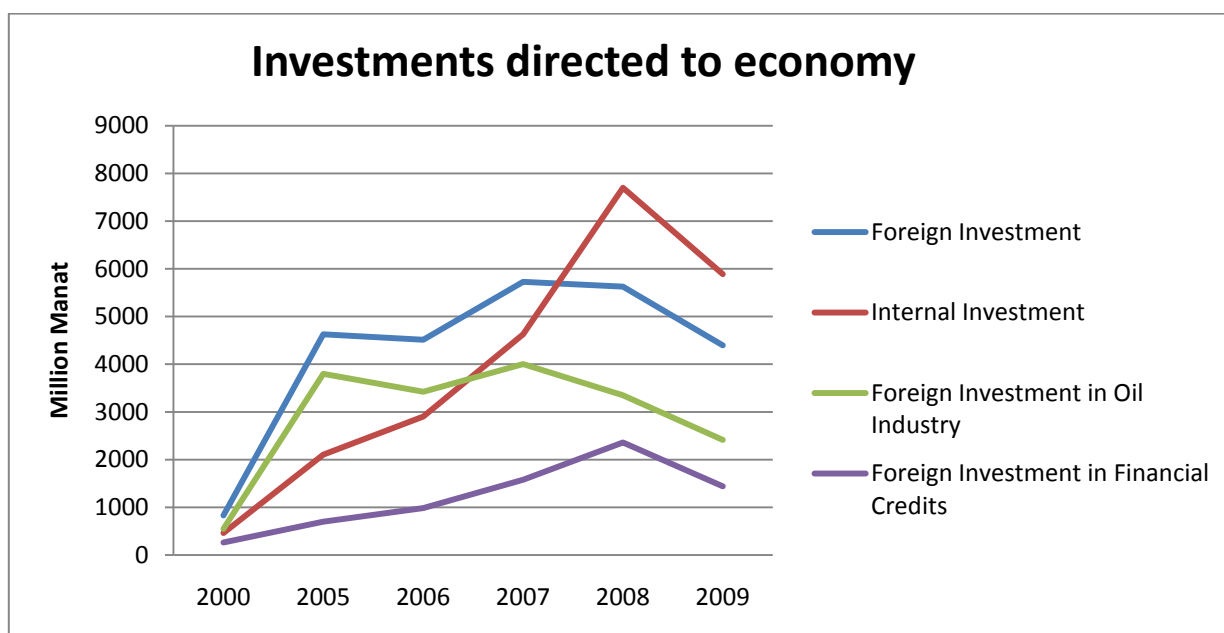


Figure 20.<sup>94</sup> Shows investments directed into the economy of Azerbaijan, from foreign sources as well as internal investment. Furthermore it shows how foreign investment is distributed between investment in the oil industry and investment in financial credits.

Diversification in investments would allow Azerbaijan to move away from its dependence on oil revenues. Investing in different sectors of the economy would promote long term sustainable growth. Figure 21 shows that the increase in the number of acting enterprises in Azerbaijan has grown slowly over the period specified. The growth from 2000-2005 exceed the growth from 2005-2009.

<sup>94</sup> State Statistical Committee of the Republic of Azerbaijan. "Azerbaijan in Figures: Investments directed to economy." <http://www.azstat.org/publications/azfigures/2010/en/020.shtml>

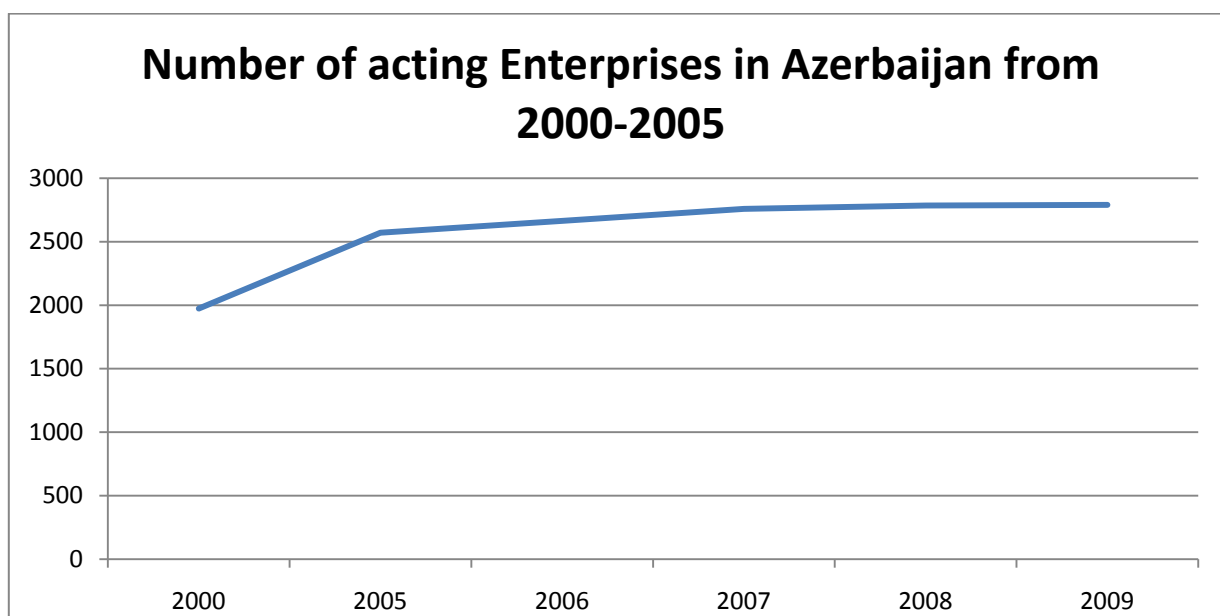


Figure 21.<sup>95</sup> Shows the number of acting enterprises in Azerbaijan from 2000-2005.

This trend is worrying as it shows that little of the foreign and internal investment visible in Figure 20 is going into the promotion of new enterprises in different economic sectors. Investment in new enterprises could result in the increase of competitiveness on global markets, as the rise in volume produced often leads to decreases in production costs.

Overall, there is a need for investment in the non-oil sectors of the economy in order to allow goods produced in Azerbaijan to be more competitive on international markets. The volume of tradable goods should increase and the prices must be competitive. To achieve this there is a need for major investments in modern, more productive machinery.

#### **4 -2- Deindustrialization of the Economy:**

Another symptom of Dutch disease, the deindustrialization of non-oil sectors is a common result of the appreciation of the local currency which leads to loss of competitiveness. When it is no longer attractive to produce certain goods and services, stakeholders often abandon the industry to seek more rewarding opportunities.

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<sup>95</sup> Ibid.

Figure 22 shows the number of people engaged in industry from 2000-2009. It is visible that more people were engaged in industry in 2000 than in 2009. Figure 9 shows that only 1 percent of the population is employed in the extractive industry and that the biggest portion of the population is employed by the agricultural sector (38 percent).

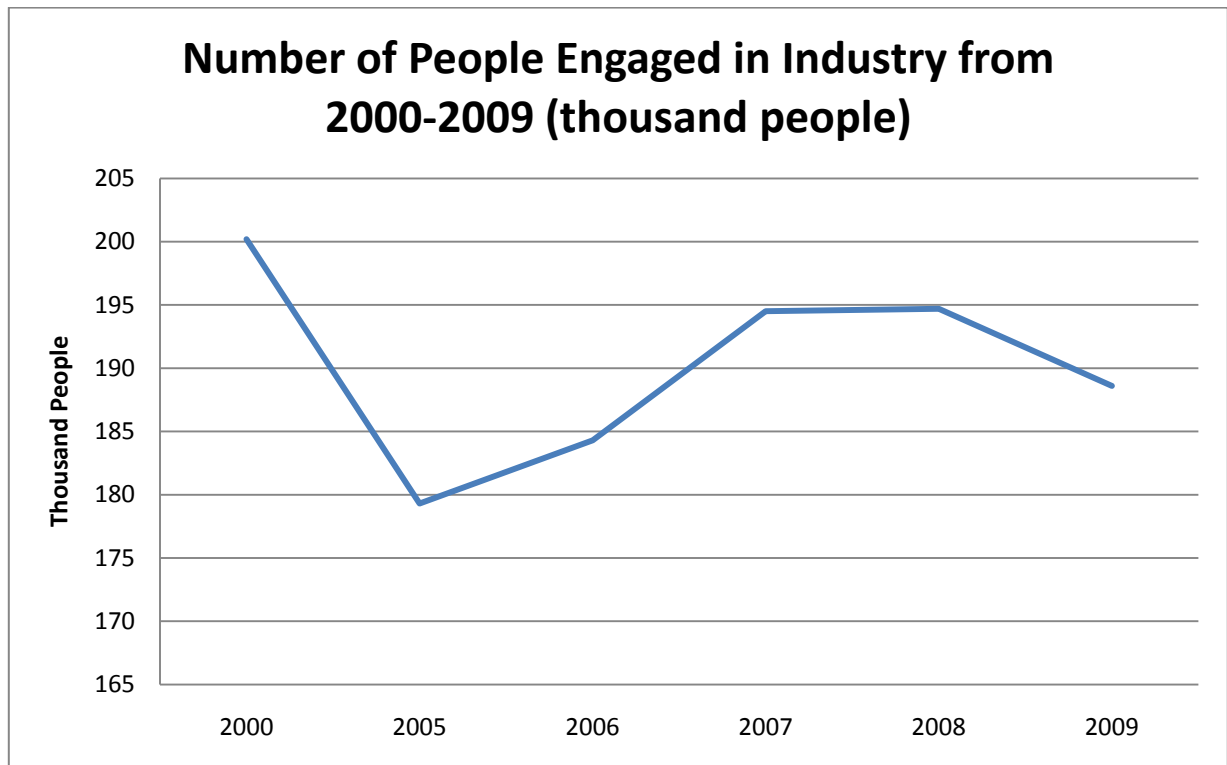


Figure 22.<sup>96</sup> Shows the number of people engaged in industry in Azerbaijan from 200-2009.

Figure 23 shows that since the collapse of the Soviet Union, there was large scale de-industrialization until 1998 when the figures began to take an upward turn. This change though has been very slow and is proportional to the decrease of the number of people engaged in the agricultural sector since 1998. This shows that the labor force is leaving the primary industry and moving towards other forms of industry.

Furthermore it is visible that overall, the number of people involved in services has been on the rise since Azerbaijan's independence. Services are part of the non-tradable sector and movement away from the tradable sector towards the non-tradable sector is a sure sign of de-industrialization.

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<sup>96</sup> Ibid.

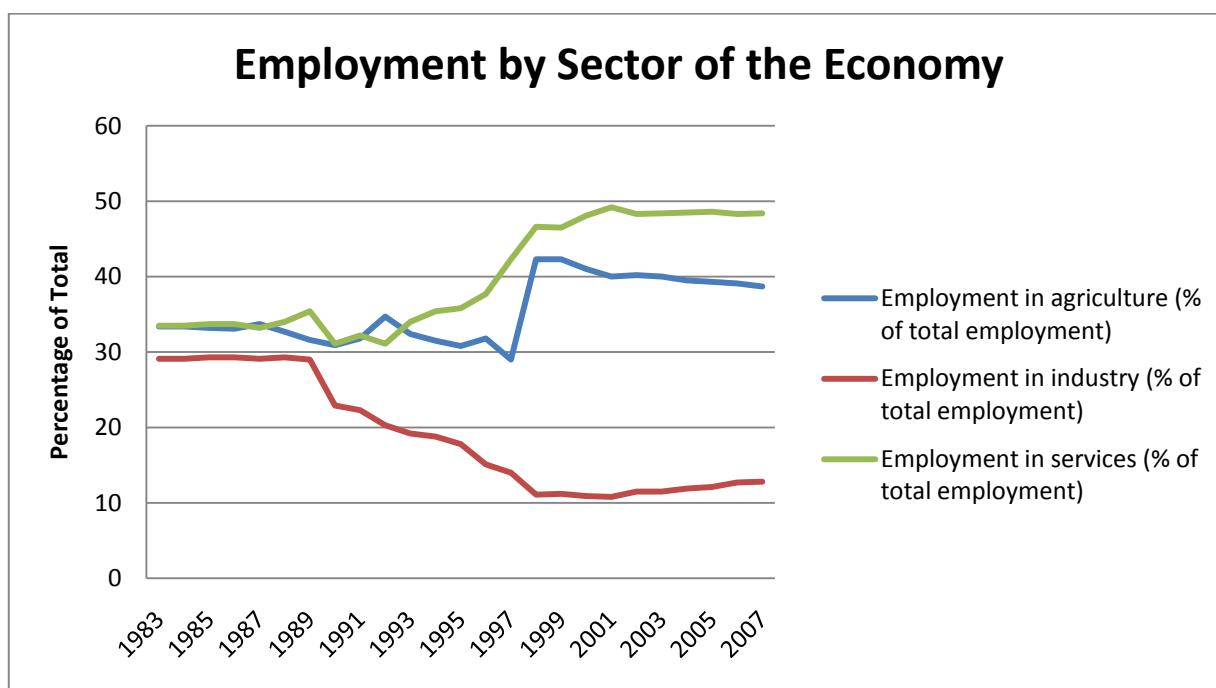


Figure 23.<sup>97</sup> Shows the percentage of the total work force employed by sector of the economy.

According to the IMF, in 2008, “non-oil activity responded strongly to the exceptional fiscal stimulus and growth accelerated to about 15 percent, led by a robust expansion in construction, services and agriculture.” On the other hand, “non-oil GDP growth slowed from 16 percent in 2008 to 3 percent in 2009.” The IMF expected non-oil GDP growth recover and rise to 4.2% in 2010.<sup>98</sup>

Despite these reports, Azerbaijan’s state budget expenditures in the economy and in social and cultural activities have increased at a rapid rate in recent years. According to the state statistical committee, expenditures for the financing of the economy increased from 444.7 million Manat in 2005 to 4373.9 million Manat in 2009. This shows that the government is increasing their investments in the national economy at a rapid rate. Furthermore, investments in social and cultural activities increased from 843.3 million Manat in 2005 to 2763.0 million Manat in 2009. The largest increases in expenditures have been seen in education and in funding for social

<sup>97</sup> World Bank. “Azerbaijan country data.” <http://data.worldbank.org/country/azerbaijan>

<sup>98</sup> IMF. “IMF Executive Board Concludes 2010 Article IV Consultation with Republic of Azerbaijan.” <http://www.imf.org/external/np/sec/pn/2010/pn1058.htm>

security. Despite this, health care has only seen a relatively small rise in state budget expenditures with an increase of only 287.1 million Manat from 2005 to 2009.

The efforts to direct more state expenditures to the economy and to social and cultural activities play an essential role in mitigating the effects of the resource curse. According to the figures though, despite considerable increases in spending, the non-oil sector of the economy is still being overshadowed by the oil sector.

There are elements indicating that de-industrialization has been occurring in Azerbaijan. The movement of the labor force towards the non-tradable sector such as services, and away from the primary industrial sector, agriculture, along with the extremely slow increase in labor in the industrial sector, since 1998, all points to de-industrialization. In the following part of this chapter, the most worrying element of de-industrialization is addressed, the weakness of the agricultural sector in Azerbaijan.

#### **4 - 3 – Weakness of the Agricultural Sector:**

Agriculture is commonly a supporting pillar for many economies; many countries owe a large portion of their GDP to their agricultural sector, China (10.6 percent), India (17 percent), (Mozambique (28.7 percent), Nepal (35 percent), Nigeria (33.1 percent), Pakistan (20.8 percent), and Sudan (32.1 percent). These countries are developing countries and rely heavily on agriculture to support their economies.

According to the USACC (US –Azerbaijan Chamber of Commerce), nine of the world's eleven climate zones, that provide the perfect environment for the cultivation of a wide variety of agricultural products, are present in Azerbaijan. Furthermore the USACC states that multiple agricultural products, (among which are pomegranate, feijoa, grape juice, olives, tomatoes, forestry, cotton, tobacco, berries, and hazelnuts), produced in Azerbaijan are competitive on international markets.<sup>99</sup>

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<sup>99</sup> USACC. "U.S. - Azerbaijan Food and Agriculture Trade Mission - 21-26 May, 2007." 2007. <http://usacc.org/content.php?type=event&id=3205>

“Since almost 50% of Azerbaijan's population resides in rural areas, the food and agriculture sector constitutes an important part of the job market. In 2005, some 39 percent of workers were engaged in the agriculture and forestry business. Rural development is a top priority for the Azerbaijani government and demand for agricultural input is growing rapidly.”<sup>100</sup>

A shrinking agricultural sector is a sure sign of the resource curse. Oil and gas revenues lead to investments in the non-tradable sectors of the economy (Chapter 4-4.) such as construction and transportation. This is called de-industrialization (Chapter 4-2.) which is a major symptom of Dutch Disease (Chapter 3-1.). The agricultural sector is often hard hit by de-industrialization due to lack of investment and movement of the work-force towards other sectors of the economy in search for better prospects.

In the case of Azerbaijan, the agricultural sector employs the largest portion of the population (Chapter 3-3.) The agricultural sector is essential to the economy.

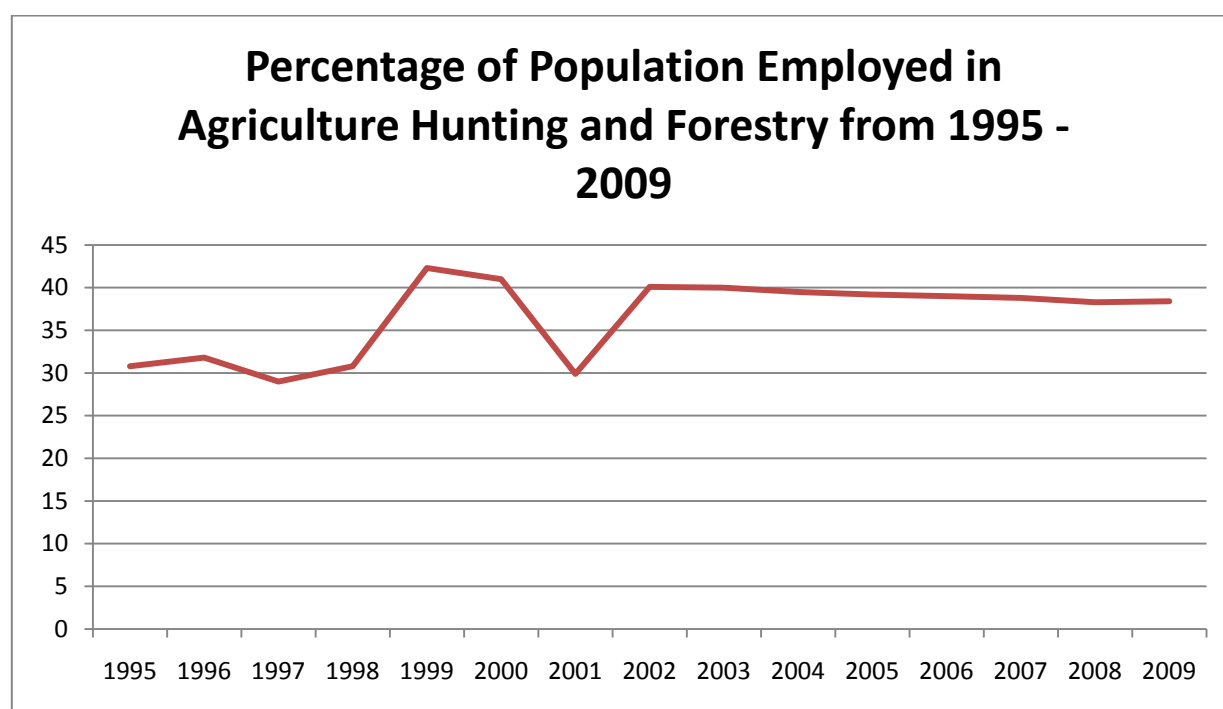


Figure 24.<sup>101</sup> Shows the percentage of the population employed in the Agriculture, Hunting and Forestry sector from 2000 to 2009.

<sup>100</sup> Ibid.

<sup>101</sup> The Statistical Committee of the Republic of Azerbaijan. [http://www.azstat.org/statinfo/labour/en/002\\_1.shtml](http://www.azstat.org/statinfo/labour/en/002_1.shtml)

The decline in the percentage of the population employed in agriculture, hunting and forestry from 2002 onwards (Figure 24) can be explained by an increase in the percentage of the population employed in the construction sector.<sup>102</sup> Construction is a growing sector in Azerbaijan and may offer better prospects to the labor force than agriculture.

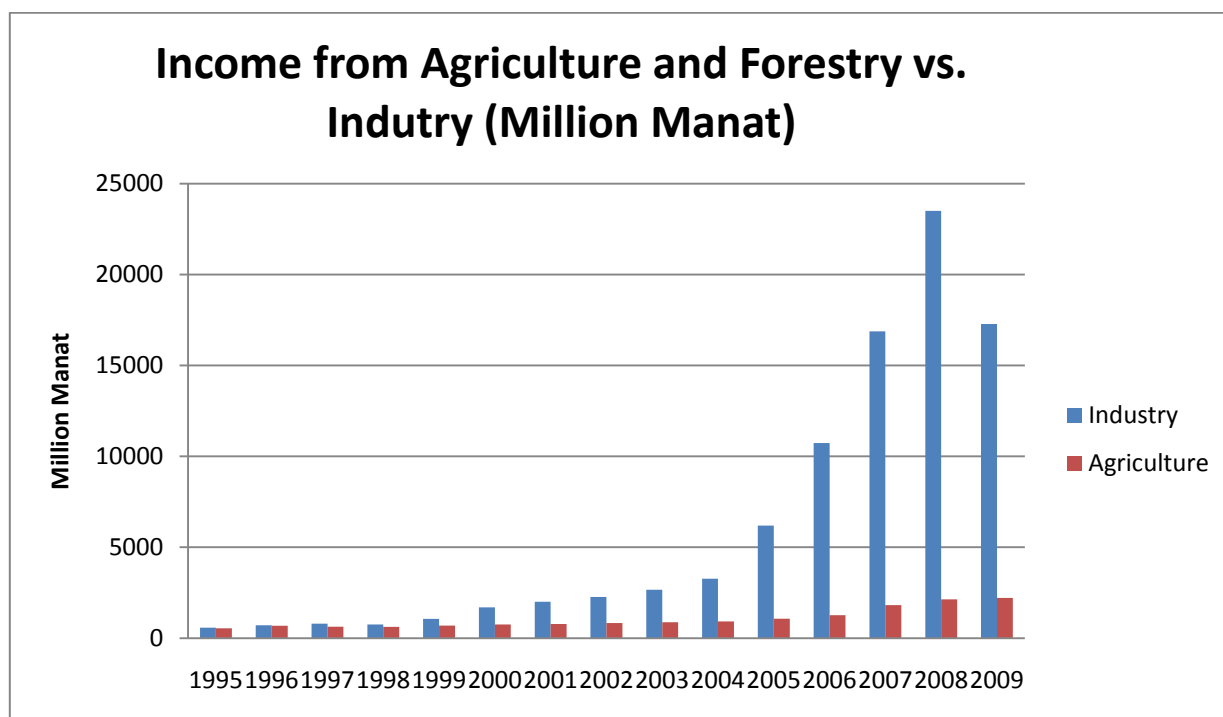


Figure 25.<sup>103</sup> Shows the income from the Agriculture and Forestry sector vs. Income from the Industrial sector from 1995 to 2009.

<sup>102</sup> World Bank. "Azerbaijan Country Economic Memorandum. A new Silk Road: Export led diversification." Report No. 44365-AZ. December 23<sup>rd</sup> 2009.

<sup>103</sup> The Statistical Committee of the Republic of Azerbaijan.

[http://www.azstat.org/~hagigat/azs\\_work/statinfo/agriculture/en/005.shtml](http://www.azstat.org/~hagigat/azs_work/statinfo/agriculture/en/005.shtml)

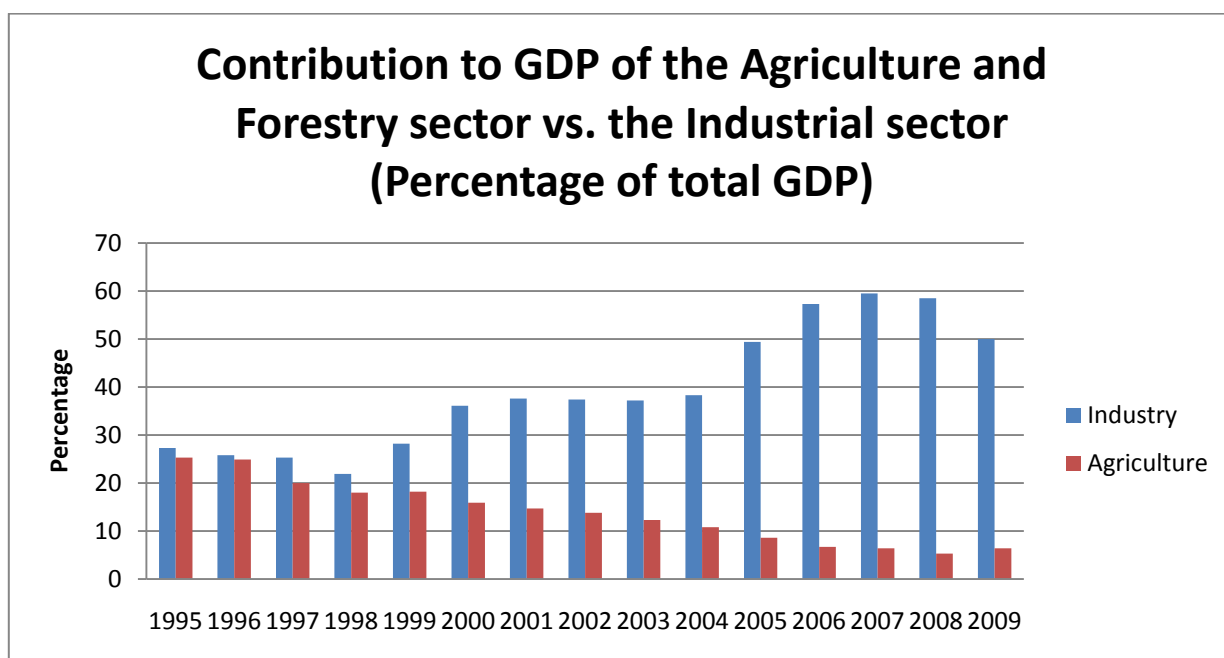


Figure 26<sup>104</sup> shows the contribution to the total GDP, of the agriculture and forestry sector vs. that of the industrial sector from 1995-2009.

Figure 25 shows that revenues from the agriculture and forestry sector of the economy have been increasing over the period specified. On the other hand it is also visible in Figure 26 that the percentage of the nation's GDP that the agricultural and forestry sector represents is in decline over the same period. This shows that despite the increase in revenues, the agricultural sectors contributions to GDP are decreasing in importance.

Furthermore Figure 25 shows a steep increase in the revenues from industry over the same period as well as an increase in the industries revenues as a percentage of GDP in Figure 26. This can lead to the conclusion that the industrial sector in Azerbaijan is increasingly contributing to the nations GDP while the role of the agricultural and forestry sector is decreasing.

These figures can be explained by a lack of investment in the agricultural sector as can be seen below as well as the high value of the Manat. (Chapter 3-1.)

<sup>104</sup> Ibid.



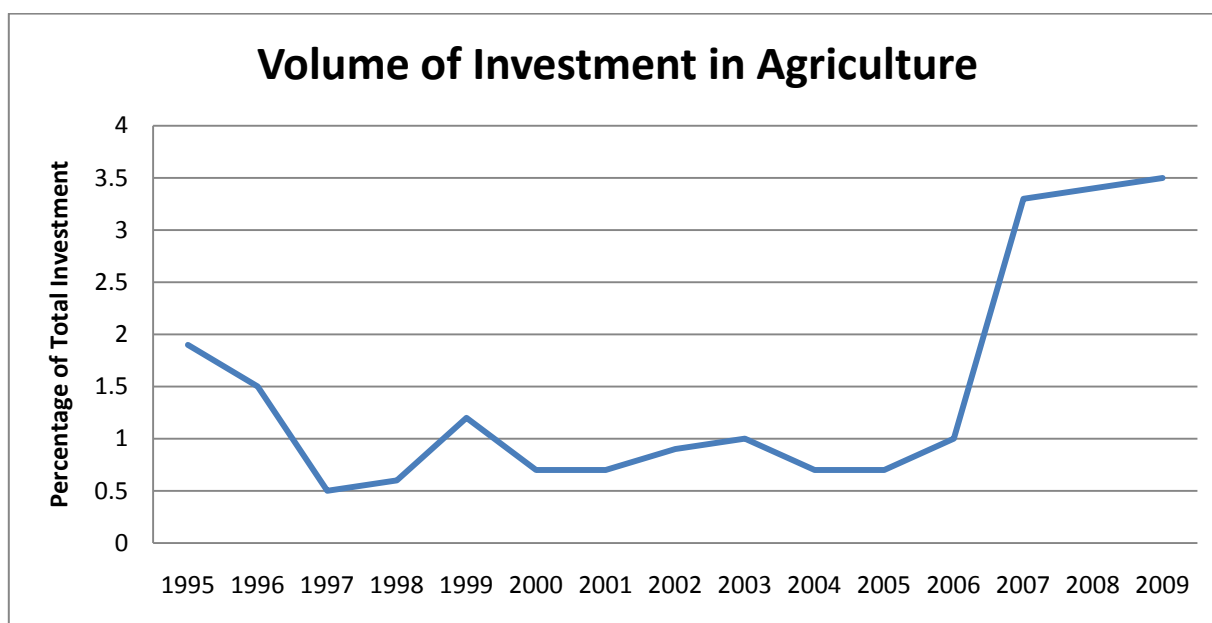


Figure 27.<sup>105</sup> Shows the Volume of Investment in agriculture as a percentage of total investments for each year for the period of 1995-2009.

Figure 27 shows that investment in agriculture has more than tripled since 2006. As a share of total investment though, 3.5 percent represents 266.6 million Manat, which is only 8.3 percent of the investments that go into industry.

Investing in the agricultural sector of the economy could allow Azerbaijan to move away from their dependence on the oil and gas industry. Furthermore, a part of Azerbaijan's agricultural products are currently competitive on the international market, increasing the amount of agricultural products to combat the trade imbalance between imports and exports of non-oil related products in Azerbaijan.

The current situation in the agricultural sector reflects the general situation in the non-oil based sectors of industry. Despite projects such as the Samur Absheron irrigation system, which received 112.1 million Manats from January to September 2010 from the State Oil Fund, there is very little growth visible in the agricultural sector. The percentage of the labor force involved in agricultural activities is shrinking, oil and gas revenues are dwarfing agricultural revenues and

<sup>105</sup> Ibid.

the appreciation of the Manat is leading to a lack of competitiveness in global markets, a situation which will be made worse if the volume of agricultural goods decreases.

Investments in the agricultural sector of the economy are vital, whilst they are increasing in Azerbaijan there is a need for much larger volumes of investment to ensure that this sector, which is the primary employer in the country, grows and prospers. Agricultural products are among the few industrial products of Azerbaijan that are competitive on international markets<sup>106</sup> and the development of this sector is essential to fighting the “resource curse.”

#### **4 - 4 - Tradable vs. Non-tradable goods:**

Tradable goods can be defined as goods that can be sold in another location, distant from where they were produced. Furthermore tradability of the goods depend on the cost of transportation and the shelf-life of the goods, if these factors are lower the goods are more tradable. Tradable goods consist mainly of light industry, agricultural products, cars and other such products.<sup>107</sup>

Non-tradable goods are typically difficult or impossible to sell in locations distant from their place of manufacturing. The shorter the shelf-life and the higher the cost of transportation, the less tradable goods are. Non-tradable goods consist of products such as construction, services and construction materials.<sup>108</sup>

The growth of sectors of the economy producing non-tradable goods is one of the symptoms of Dutch disease. Spending revenues from resource extraction on the production of non-tradables in favor of tradable goods causes the tradable sector to shrink, thus leading to loss of competitiveness in global markets as non-tradables are non-competitive.<sup>109</sup>

According to Dr. Ingilab Ahmadov, “the real exchange rate is defined as the price of non-tradable goods in relation to tradable goods. A real appreciation means that non-tradable goods

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<sup>106</sup> USACC. “U.S. - Azerbaijan Food and Agriculture Trade Mission - 21-26 May, 2007.” 2007.

<http://usacc.org/content.php?type=event&id=3205>

<sup>107</sup> Ingilab Ahmadov, PhD. PowerPoint: Oil Factor’s impact to economy, Dutch Disease. Khazar University 2009/2010.

<sup>108</sup> Ibid.

<sup>109</sup> Ibid.

have become more expensive in relation to tradable goods – either because the nominal exchange rate has appreciated or because domestic price inflation (non-traded sector) is higher than abroad (traded sector).”<sup>110</sup>

According to a study conducted and Fariz Huseynov by Fakhri Javanshir Hasanov , “By using quarterly data from 2001-2007 and applying various approaches, we estimate real equilibrium exchange rate misalignment for Azerbaijani Manat (AZN) and find that AZN is slightly overvalued.”<sup>111</sup>

Figure 28 shows that the percentage of investment in the economy of Azerbaijan is highest in Industry, furthermore we see a large proportion of investment in sectors like transportation and communication which are non-tradable as is construction.

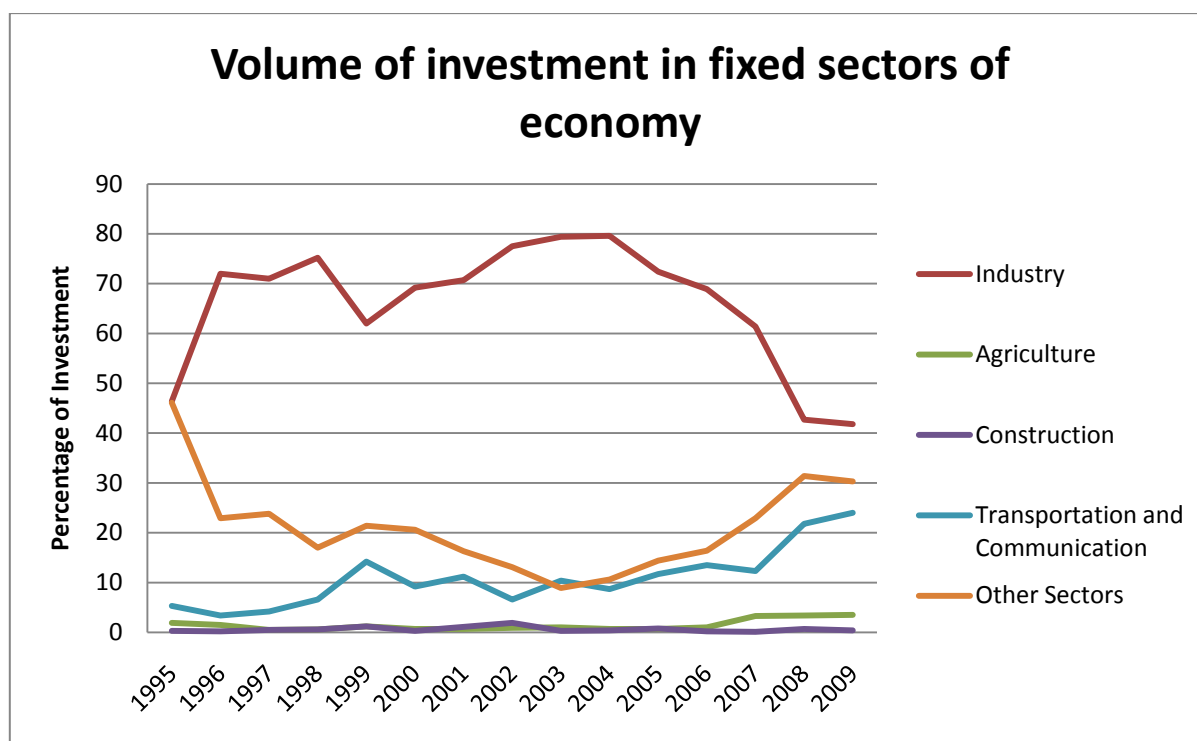


Figure 28.<sup>112</sup> Shows the Volume of Investment in Fixed Sectors of the Economy of Azerbaijan from 1995-2009 as a percentage of total investment.

<sup>110</sup> Ibid.

<sup>111</sup> Hasanov, Fakhri Javanshir and Huseynov, Fariz, Real Exchange Rate Misalignment in Azerbaijan (November 20, 2009). Available at SSRN: <http://ssrn.com/abstract=1522297>

<sup>112</sup> The Statistical Committee of the Republic of Azerbaijan.

Figure 29 shows that employment in non-tradable sectors of the economy has grown in Azerbaijan from 2000-2009 with the exception of electricity, gas and water supply and distribution. Considering that employment has risen as a whole throughout the economy, this is not surprising, but a considerable growth in the construction, transportation, storage and communications, and the real estate, renting and business activities sectors shows a shift of employed population towards the non-tradable sector.

The World Bank states that, “new opportunities in construction (initially in the oil sector, but also in real estate and later in the public sector) contributed to reducing the share of employment in the primary sectors (agriculture and fishing) by approximately 2.5 percentage points.”<sup>113</sup>

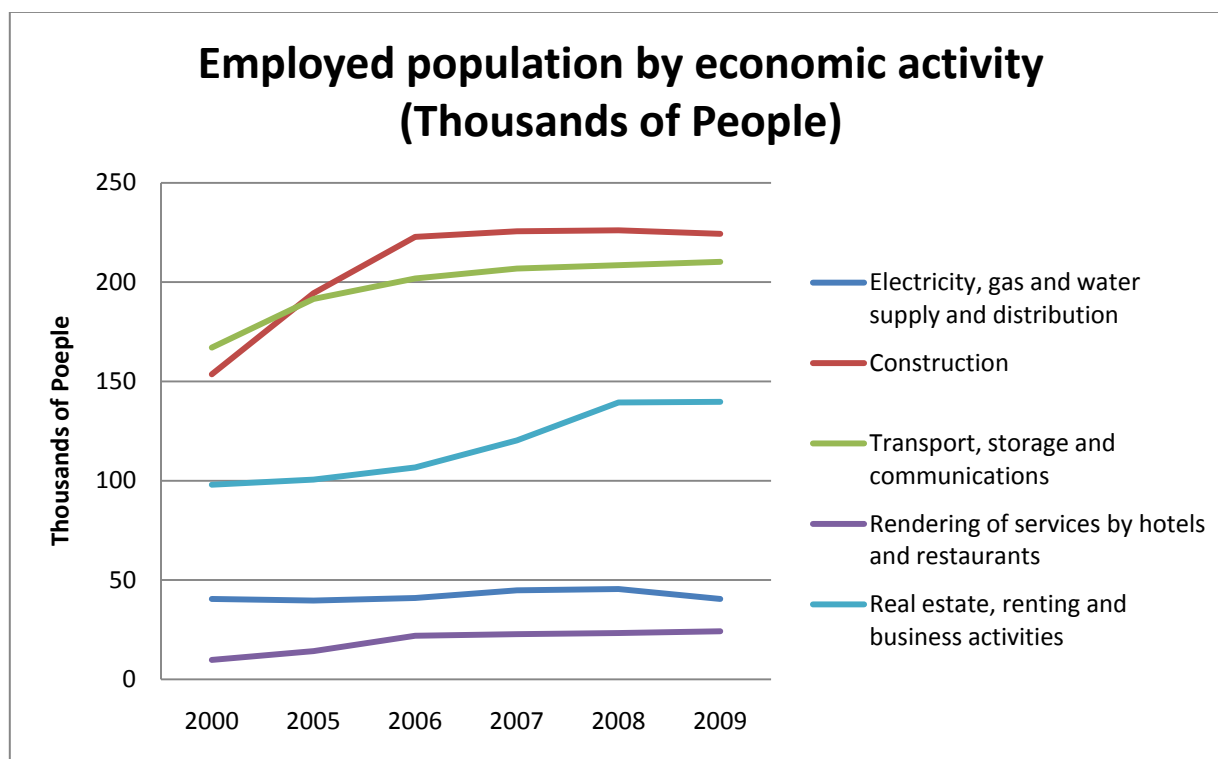


Figure 29.<sup>114</sup> Shows the number of people employed by economic activity from 2000-2009.

<sup>113</sup> World Bank. “Azerbaijan Country Economic Memorandum. A new Silk Road: Export led diversification.” Report No. 44365-AZ. December 23<sup>rd</sup> 2009.

<sup>114</sup> Ibid. <http://www.azstat.org/publications/azfigures/2010/en/005.shtml>

Movement of the population from tradable to non-tradable sector along with higher investment in non-tradable sector than in tradable sector are elements that should be of concern to the government. Azerbaijan needs to promote the development of all non-oil based industry so as to allow it to decrease its dependence on the oil and gas industry. Increasing the volume of production in general is good but moving the manufacturing sector towards the production of non-tradable goods and away from tradable goods is not a sustainable way to do so.

Keeping in mind that increasing exports in Azerbaijan is an essential part of avoiding the resource curse, non-tradable goods cannot be exported. Only the tradable sector can contribute to exports. Developing the tradable sectors of the economy is essential to Azerbaijan's future.

#### **4 - 5 - Inefficient Government Spending:**

Another symptom of the resource curse is the inefficiency of government spending. According to Svetlana Tsalik, the inflow of large revenues from the extractive sector of the economy can lead to political leaders being shielded from sensible economic planning for the future as well as political accountability. She claims that if a political leader can offer a growing pot of resources for local projects, it offers little incentive for them to make difficult choices about reducing dependence on mineral resources, or to reduce inefficiency in government spending and planning for the future.<sup>115</sup>

In resource rich countries, there is often a tendency to invest in "white elephants." The term white elephant originated in the 1850's, from a "tale that the King of Siam would award a disagreeable courtier a white elephant, the upkeep of which would ruin the courtier." This term is used in economics to describe projects with high operational costs or opportunity costs which may not have been considered before the implementation of the project.<sup>116</sup>

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<sup>115</sup> Svetlana Tsalik, of the Caspian Revenue Watch. Caspian Oil Windfalls: Who will Benefit? Copyright 2003 by Open Society Institute.

<sup>116</sup> Dictionary.com. "Definition: White Elephant." <http://dictionary.reference.com/browse/white+elephant>

It is tempting for oil rich countries to engage in projects which, in the long run, may turn out to be white elephants.<sup>117 118</sup> According to Gorkhmaz Askarov, the government of Azerbaijan often engages in projects which might be classed as white elephants. Allegedly, the government builds bridges and roads that “require reconstruction immediately after completion,” or which are “reconstructed repeatedly.” Furthermore it considers the construction of Baku’s sea port, which cost 300 million US dollars, to be a white elephant project due to the fact that Azerbaijan has no direct access to the sea.<sup>119</sup>

Furthermore Askarov claims that, “For all of these projects, there is a significant disproportion between their social necessity and their implementation costs. Spending this much money on such “white elephants,” which are not expected to generate wealth, has led to the rapid appreciation of the manat on the one hand, and on the other, the currency's declining purchasing power on the domestic market.”<sup>120</sup>

White Elephants are only one part of inefficient government spending, as seen in the previous chapter, favoring investment in non-tradable sectors over tradable sectors of the economy leads to the reduction in competitiveness in the long term. Furthermore, spending for political purposes such as elections is inefficient. According to Svetlana Tsalik, “the government of Azerbaijan spent 100 million US dollars from the oil fund to pay for pensions and to raise civil service salaries in an election year.”<sup>121</sup>

According to the Central Bank of the Republic of Azerbaijan, the state budget showed a consistent deficit throughout the period of 1997 to 2005 as shown in Figure 30. Furthermore from the period of 2006 to 2009, the state budget has shown consistent surpluses except in March 2006. Deficits were also seen in December 2007, and December 2009.

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<sup>117</sup> For examples of alleged white elephant projects please visit [http://en.wikipedia.org/wiki/White\\_elephant](http://en.wikipedia.org/wiki/White_elephant) to view a list of global cases.

<sup>118</sup> For further examples of alleged white elephant on the continent of Africa please visit MSNBC at [http://www.msnbc.msn.com/id/22380448/ns/world\\_news-africa/](http://www.msnbc.msn.com/id/22380448/ns/world_news-africa/)

<sup>119</sup> Gorkhmaz Askarov. “Viewpoint: Azerbaijan’s White Elephants.” RFLERL. <http://www.rferl.org/content/article/1079690.html>

<sup>120</sup> Ibid.

<sup>121</sup> Svetlana Tsalik, of the Caspian Revenue Watch. Caspian Oil Windfalls: Who will Benefit? Copyright 2003 by Open Society Institute.

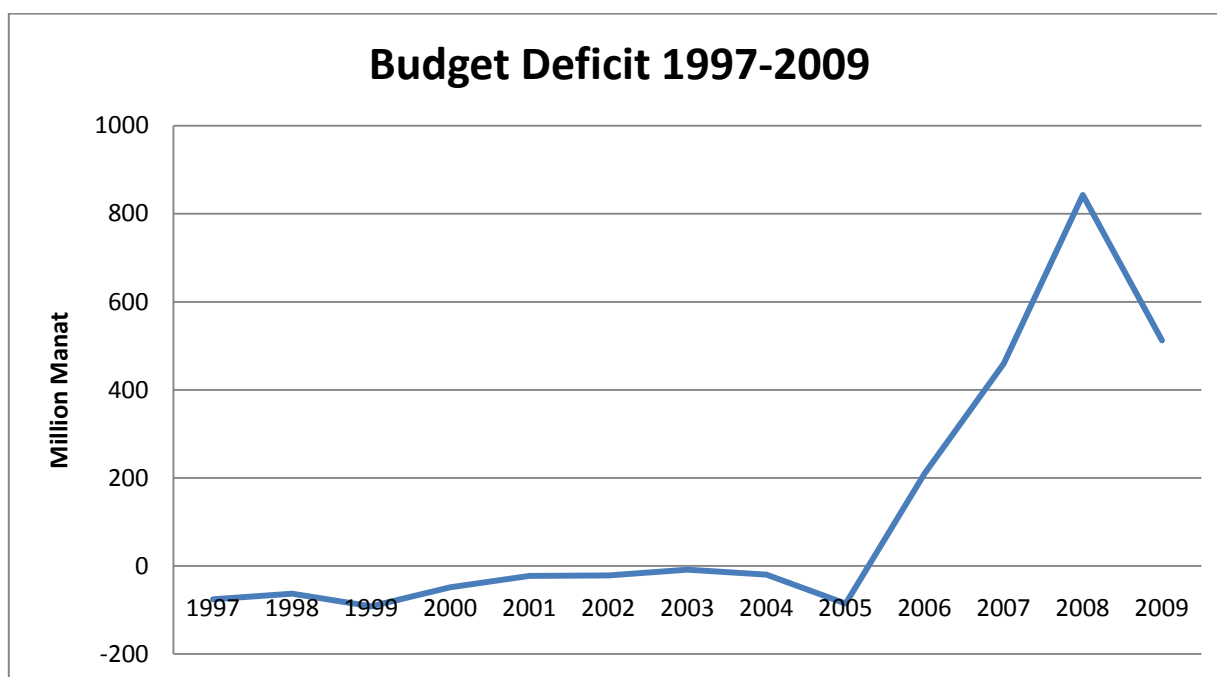
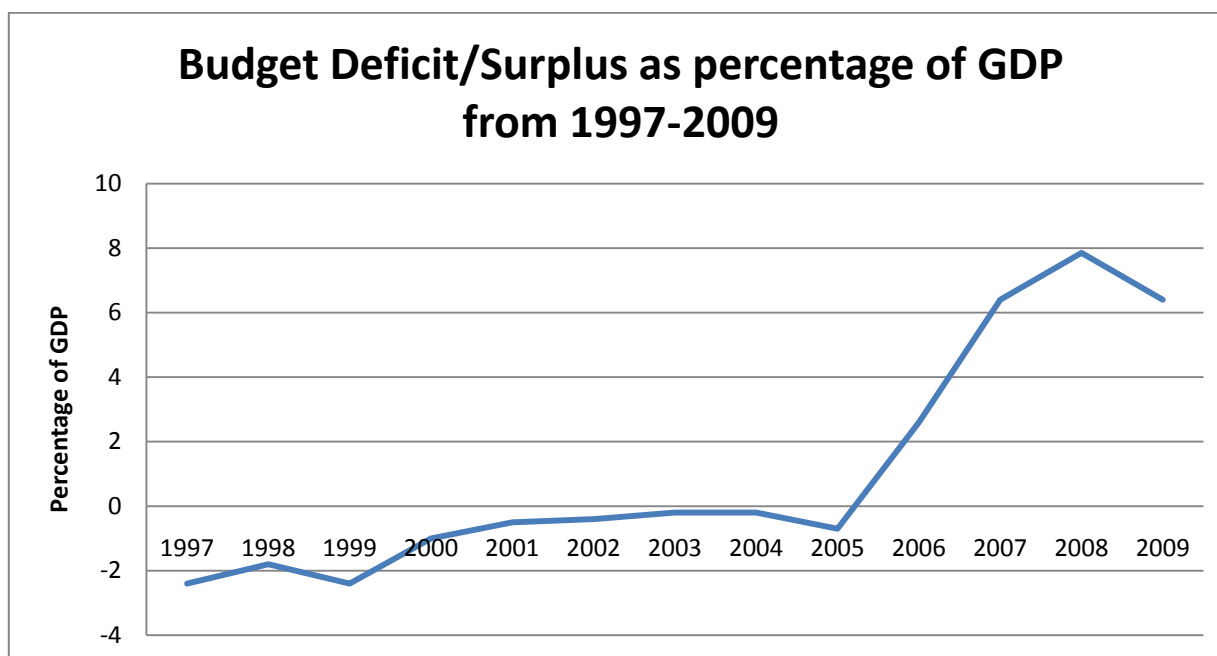


Figure 30.<sup>122</sup> Shows the deficit of the state budget of Azerbaijan from 1997-2005.

Figure 30 shows that during the period of 1997 to 2005, the expenditures of the state budget exceeded the revenues. This shows inefficiency in spending. Since 2006, the state budget of Azerbaijan has consistently received more revenues than the amount of expenditures.



<sup>122</sup> Central Bank of the Republic of Azerbaijan. "Table 1.3. Major indicators of the State Budget of the Republic of Azerbaijan" [http://www.cbar.az/assets/94/1.3\\_eng.pdf](http://www.cbar.az/assets/94/1.3_eng.pdf)

Figure 31.<sup>123</sup> Shows the deficit/surplus of the state budget as a percentage of GDP for each year from 1997 to 2009.

Figure 31 shows that the deficit seen from 1997 to 2005 represents between 2.4 and 0.7 percent of GDP which is low. Furthermore, the surpluses seen in the period of 2006 to 2009 peaked in 2008 at 7.85 percent of GDP.

The peak in the budget surplus in 2008, which can be seen in Figures 30 and 31, can be partially attributed to the increased income of profit taxes which jumped from 2457.7 million Manat in 2007 to 2862.3 million Manat in 2008. Revenue from profit taxes then fell to 1329.2 million Manat in 2009 causing the decrease in the budget surplus over this period.<sup>124</sup> Furthermore, the non-tax revenues increased from 793.8 million Manat in 2007 to 4037.7 million Manat in 2009 according to the State Statistical Committee. This was a 509 percent rise in non-tax revenues.<sup>125</sup> This increase can be partially contributed to an 88% increase in transfers from SOFAZ from 2007 to 2008 raising the share of SOFAZ transfers in the state budget from 9.7 percent to 35.3 percent.

In Figure 32, it is visible that the state budget receives a large part of its revenues from oil related source. Profit tax and a large part of non-tax revenues result from the oil industry.

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<sup>123</sup> Ibid.

<sup>124</sup> Ingilab Ahmadov, PhD, Kenan Aslanli. "State Oil Fund of Azerbaijan Republic: from single account to main Source of public finance." November 2010. PPMC

<sup>125</sup> State Statistical Committee of the Republic of Azerbaijan. "State Budget Revenues and Expenditures." <http://www.azstat.org/publications/azfigures/2010/en/020.shtml>



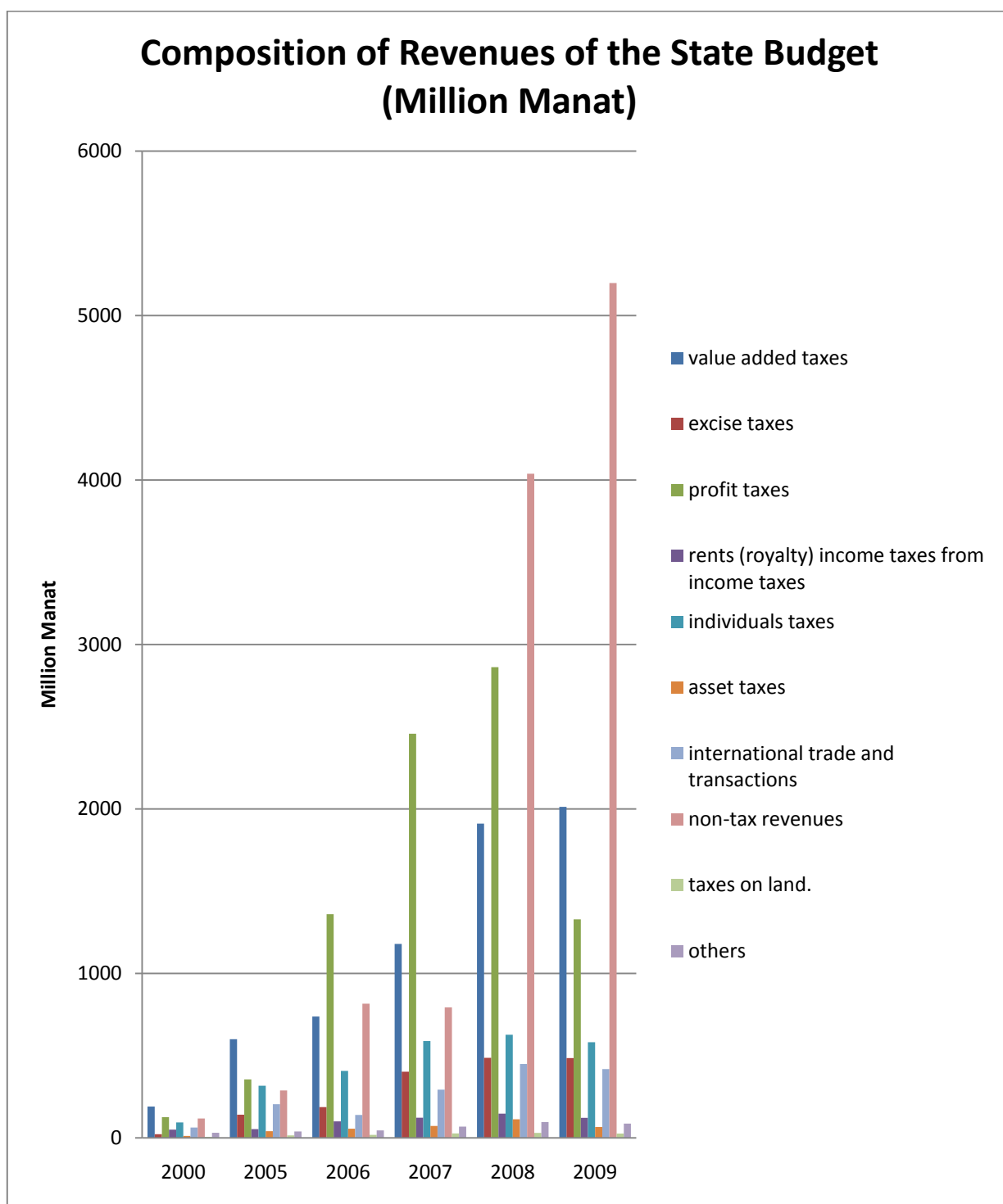


Figure 32.<sup>126</sup> Shows the composition of the revenues received by the state budget from 2000-2005.

<sup>126</sup> Ibid.

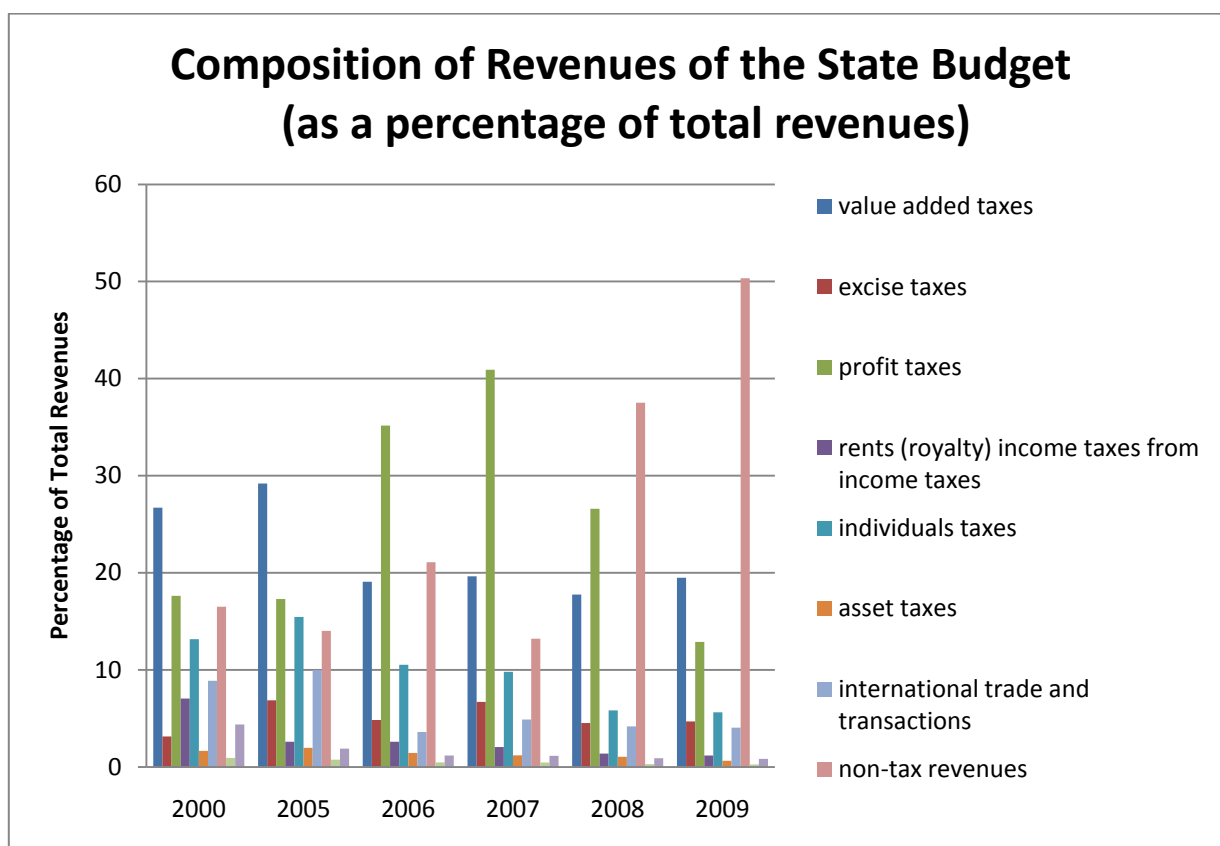


Figure 33.<sup>127</sup> Shows the composition of revenues received by the state budget as a percentage of total revenues received from 2000-2009.

Figure 33 shows that the percentage of revenues represented by oil related income is high in relation to non-oil related income. The rapid growth in the percentage that non-tax revenues contribute to the budget can be partially explained by increases, since 2007, in the volume of transfers from SOFAZ to the state budget.

Considering that 57.7 percent of GDP in September 2010 was oil-related, it is possible to conclude that the majority of revenues to the state budget are oil-related. Thus the efficiency of expenditures is questionable. The majority of revenues received by the state budget results only from the sale of oil and gas then the proportion of non-oil revenues to expenditures is imbalanced. It is the amount of revenues received from the extractive industries that pushes up the expenditures.

<sup>127</sup> Ibid.

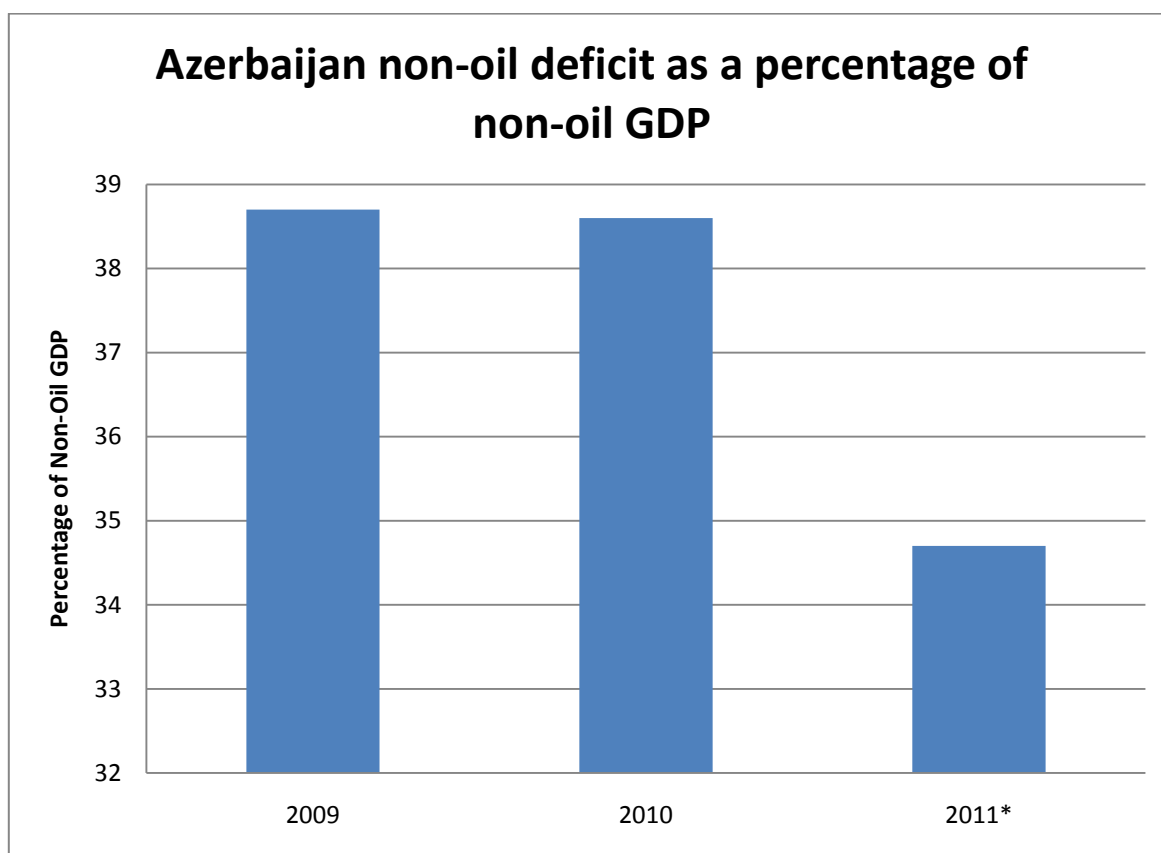


Figure 34.<sup>128</sup> Shows the non-oil deficit of Azerbaijan as a percentage of the non-oil GDP from 2009 to 2011. \* the figures for 2011 are estimated by the IMF.

Figure 34 shows that the non-oil deficit in Azerbaijan was above 38 percent in 2009 and 2010 despite surpluses in the state budget for the same period. The IMF estimates that the non-oil budget deficit will drop to 34.7 percent in 2011. Furthermore the IMF estimates that the state budget surplus will rise to 14.4 percent of general GDP in 2011.

Despite the predicted drop in 2011 of the non-oil deficit, the figures are still high. According to ABC.az, “Market sources say that non-oil sector of Azerbaijan’s economy is plunging into crisis in connection with lack of working capital and investments.”<sup>129</sup> It is essential that the government increase investments to avoid further de-industrialization of the non-oil sectors of the economy.

<sup>128</sup> ABC.AZ. “Azerbaijan’s non-oil deficit to fall to 34.7% of non-oil GDP.” October 28<sup>th</sup> 2010.

<http://abc.az/eng/news/49051.html>

<sup>129</sup> ABC.AZ. “Non-oil Sector of Azerbaijani Economy to Stop in 4-6 Months.” November 22<sup>nd</sup> 2010.

<http://abc.az/eng/news/49558.html>

## **Chapter 5 - How to Mitigate the Resource Curse - Azerbaijan Experience:**

According to Svetlana Tsalik, it is very challenging to minimize the negative impacts oil revenues may have on resource rich countries, especially on oil-rich countries, this may be the case even when leaders are driven by good intentions to create economic and human development from resource wealth. Countries with weak or developing democratic institutions, public administration systems and civil services are most vulnerable to the resource curse.<sup>130</sup>

One of the problems Azerbaijan faces is that its institutions, systems and services are young and immature. During the Soviet era, Azerbaijan had few or no institutions as all the power and decision making was concentrated in Moscow. Since its independence, Azerbaijan has had to deal with both the development of its institutions as well as the development of its primary industry, the extractive Industry.

There are three main reasons why Azerbaijan must correctly manage its oil wealth. First, Azerbaijan's economy is particularly dependent on its oil industry, more so than other Caspian states such as Kazakhstan which has triple the proven and potential oil reserves and about four times more proven and possible gas reserves. Two thirds of industrial production in Azerbaijan is dominated by the oil sector which comprises over 90 percent of its exports. Furthermore, Azerbaijan has experienced, "the inflation, real exchange rate appreciation, and crowding out of the non-oil sector that is symptomatic of Dutch Disease."<sup>131</sup>

Secondly, Azerbaijan's oil production is estimated to peaked in 2014, output will slow down until 2020, and in 2035 production will decrease to 0.9 million bbl./day .<sup>132</sup> This means that Azerbaijan has a short period to maximize the potential gains that its oil and gas reserves have to offer.

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<sup>130</sup> Tsalik, Svetlana of the Caspian Revenue Watch. Caspian Oil Windfalls: Who will Benefit? Copyright 2003 by Open Society Institute.

<sup>131</sup> Ibid.

<sup>132</sup> IEA. "Azerbaijan's Oil Production to peak in 2014: EIA." [http://www.azernews.az/site/Oil \\$ Gas/26737-Azerbaijan?s\\_oil\\_production\\_to\\_peak\\_in\\_2014:\\_IEA](http://www.azernews.az/site/Oil_$ Gas/26737-Azerbaijan?s_oil_production_to_peak_in_2014:_IEA)

Thirdly, due to the on-going Azerbaijan-Armenia conflict, approximately 800, 000 Azerbaijanis have been internally displaced. This adds a further burden to the government which has to “restore normal lives to this displaced population.”<sup>133</sup>

In this chapter a discussion is undertaken on methods used to mitigate the effects of the resource curse in Azerbaijan. An analysis is done of the tools and methods used by the state as well as NGO's to minimize the negative impact of oil revenues and maximize potential benefits. Three important areas are covered in this chapter, an analysis of SOFAZ, transparency, and the establishment and function of NGO's.

### **5 - 1 - Sovereign Wealth Fund - SOFAZ:**

The State Oil Fund of the Republic of Azerbaijan was established on December 29<sup>th</sup> 1999 by presidential decree #240, "On Establishment of the State Oil Fund of the Republic of Azerbaijan". "Statutory Regulations of the State Oil Fund of the Republic of Azerbaijan was approved by the President of the Republic of Azerbaijan # 434 dated December 29, 2000."<sup>134</sup>

The fund acts as both a stabilization fund and a savings fund to secure oil and gas revenues for future generations. It is neither one nor the other, but according to Svetlana Tsalik, “its rules are ambiguous enough to allow it to be used for either.” Furthermore the fund also serves to stabilize the exchange rate, through sterilization, by keeping foreign currency received from the sale of oil and gas out of the monetary system. Another possible function of the fund is to help cushion the budget against price shocks.<sup>135</sup>

The oil fund was a creation resulting from close collaboration between the IMF, the World Bank and the government of Azerbaijan. The motivation for the establishment of the fund came from the governments understanding of the problems other developing countries had encountered in managing oil wealth. In SOFAZ's annual report they explain that, “the experience of oil-rich

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<sup>133</sup> Tsalik, Svetlana of the Caspian Revenue Watch. Caspian Oil Windfalls: Who will Benefit? Copyright 2003 by Open Society Institute.

<sup>134</sup> SOFAZ. [www.oilfund.az](http://www.oilfund.az)

<sup>135</sup> Tsalik, Svetlana of the Caspian Revenue Watch. Caspian Oil Windfalls: Who will Benefit? Copyright 2003 by Open Society Institute.

countries suggests that oil revenues easily gained are not always rationally used. Indeed, excessively high misuse and internal dealings can be observed in most cases...Preventing such misuse and strengthening financial discipline...were also major reason for [the] establishment of the State Oil Fund.”<sup>136</sup>

As Svetlana Tsalik states, SOFAZ has had a positive impact since its establishment both due to its help in mitigating the real exchange rate and in improving the international image of Azerbaijan. She states that Fitch, a global ratings agency, elevated the rating for Azerbaijan to BB in 2002, stating that this was specifically due to the creation of the Oil Fund.<sup>137</sup>

Founding documents of the Oil Fund suggest that its purpose is to promote the non-oil sector as well as human development. However, there are no criteria on how the expenditures are to be selected. This has led to diverse expenditures ranging from providing assistance to refugees to funding projects such as the BTC pipeline. According to Tsalik, “SOFAZ is subordinate directly to the president and lacks sufficient mechanisms for oversight.”<sup>138</sup>

According to SOFAZ, “the Fund’s activity is directed to the achievement of the following objectives:

- Preservation of macroeconomic stability, ensuring fiscal-tax discipline, decreasing dependence on oil revenues and stimulating development of the non-oil sector
- Taking into account that oil and gas are depletable resources ensuring intergenerational equality with regard to the country's oil wealth and accumulate and preserve oil revenues for future generations
- Financing major national scale projects to support socio-economic progress”<sup>139</sup>

According to SOFAZ the main sources of revenues include:

- Proceeds generated under production sharing agreements from sales of the Republic of Azerbaijan's share of hydrocarbons;

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<sup>136</sup> Ibid.

<sup>137</sup> Ibid.

<sup>138</sup> Ibid.

<sup>139</sup> SOFAZ. “Goals and Objectives.” <http://www.oilfund.az/en/content/3>

- Bonuses paid under the terms of production sharing agreements;
- Acreage fees paid by foreign investors for use of the contract areas in connection with the development of hydrocarbon resources;
- Dividends paid under the terms of production sharing agreements;
- Revenues generated from the transit of oil and gas over the territory of the Republic of Azerbaijan;
- Revenues generated from the transfer of assets from investors;
- Revenues from management of SOFAZ assets;
- Grants and other disinterested aid.
- Other income.<sup>140</sup>

According to Tsalik, even though Azerbaijan has been aggressively channeling a major part of its oil and gas revenues away from the state budget, there is the risk that SOFAZ funds cannot be used to absorb price shocks, which may lead to the government “taking advantage of the ambiguity surrounding SOFAZ’s expenditure rules to buy government securities and thereby cover its budget deficit.” This situation could lead to SOFAZ becoming the biggest creditor to the government and eventually its resources would dissolve in the general flow of government expenditures.<sup>141</sup>

Taxes paid by State Oil Company of the Republic of Azerbaijan (SOCAR), do not constitute part of the revenues which are received by SOFAZ, they are paid directly into the state budget.<sup>142</sup>

Figure 35 shows that the biggest portion of revenues in this period was from the sale of profit oil and gas. Furthermore the majority of expenditures were covered by transfers to the state budget. Transfers to the state budget from SOFAZ increased from 130 million Manat in 2004 to 3,800 million Manat in 2008 according to the World Bank.<sup>143</sup>

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<sup>140</sup> SOFAZ. “Frequently asked Questions.” <http://www.oilfund.az/en/content/21/85#2>

<sup>141</sup> Ibid.

<sup>142</sup> Tsalik, Svetlana of the Caspian Revenue Watch. *Caspian Oil Windfalls: Who will Benefit?* Copyright 2003 by Open Society Institute.

<sup>143</sup> World Bank. “Azerbaijan Country Economic Memorandum. A new Silk Road: Export led diversification.” Report No. 44365-AZ. December 23<sup>rd</sup> 2009.

Revenues (Million Manat) (January – September 2010)	
TOTAL	9578.2
Profit Oil and Gas	9346
BTC (State Share)	105
Transit Payments	5.4
Acreage Payments	1.2
Sale of Assets Received from Foreign Companies	1.1
Asset Management	119.5
Expenditures (Million Manat)	
TOTAL	3944.6
Transfer to State Budget	3625
Social Projects	80
Samur Absheron Irrigation System	109.6
Oghuz-Gabala-Baku Water Supply System	112.1
“State Program on Education of Azerbaijani Youth Abroad in the Years 2007-2015”	3.8
Baku-Tbilisi-Kars Railway	2.9
Administrative and operational expenses	11.2

Figure 35.<sup>144</sup> Show the revenue and expenditure statement for January-September 2010.

Rules governing SOFAZ’s expenditures are lax, according to Tsalik, “expenditure guidelines are extremely general and at the discretion of the president.”<sup>145</sup> The Fund regulations state that it can be used for, “socio-economic progress of the country,” for “solving the most important national problems,” and for the “construction and reconstruction of strategically significant infrastructure.”<sup>146</sup>

Furthermore the issue of the “necessity to promote the development and increase the competitiveness of the non-oil sector of the national economy,” should be taken into account in expenditure plans, according to the Rules for Preparation and Execution of the Annual Budget of SOFAZ.<sup>147</sup>

<sup>144</sup> SOFAZ. “SOFAZ Revenue and Expenditure Statement for January-September 2010.”

<http://www.oilfund.az/en/account/92>

<sup>145</sup> Tsalik, Svetlana of the Caspian Revenue Watch. Caspian Oil Windfalls: Who will Benefit? Copyright 2003 by Open Society Institute.

<sup>146</sup> Ibid.

<sup>147</sup> Ibid.



According to the Fund's website, "SOFAZ is a state extra-budgetary fund functioning as a separate legal entity, with its own specialist management team and government supervisory hierarchy. The Fund's operation is guided by the Constitution and laws of the Republic of Azerbaijan, Presidential Decrees and Resolutions, and the Fund's Regulations. The Fund is responsible to the President of the Republic of Azerbaijan. The Fund is also responsible to its Supervisory Board and Chamber of Accounts established by Milli Majlis (Parliament). Reestablishment and liquidation of the Fund is carried out by means of decree by the President of the Republic of Azerbaijan."<sup>148</sup>

SOFAZ's Supervisory Board is made up of 7 members and is chaired by the Prime-Minister of Azerbaijan. The 7 members consist of representatives of the executive and legislative powers, including government ministers and members of the Parliament who were appointed in accordance with presidential decree No. 73 dated November 27<sup>th</sup> 2008. The Board is to review the Fund's draft annual budget, annual report and financial statements along with independent auditor's opinion and provide its comments.<sup>149</sup>

"SOFAZ is led by the Executive Director, who is appointed and dismissed by the President of the Republic of Azerbaijan. The Fund's Executive Director carries out operational management of the Fund's activities. The Executive Director may appoint and dismisses employees of the Fund in a manner as determined by the legislation. The Investment Board, comprising senior officials of the Fund, manages all investment related activity in SOFAZ."<sup>150</sup>

"Execution of the SOFAZ budget, which has to be duly approved by the appropriate Presidential Decrees, is undertaken in line with a set of asset management guidelines (AMG) and specified expenditures. SOFAZ assets are managed in accordance with AMG approved by the Presidential Decree on "Asset Management Rules (Guidelines) for the State Oil Fund of the Republic of Azerbaijan" # 511 dated June 19, 2001"<sup>151</sup>

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<sup>148</sup> SOFAZ. "Frequently asked Questions." <http://www.oilfund.az/en/content/21/85#2>

<sup>149</sup> Ibid.

<sup>150</sup> Ibid.

<sup>151</sup> Ibid.

According to Tsalik, “one of the first provisions in the Fund’s regulations states, “The Fund shall be accountable and responsible to the President of the Republic of Azerbaijan.”” She claims that “there are no limitations to the president’s discretion,” that, “there are no checks and balances to provide oversight,” and that, “all strategic decisions are made by the president, including the decision to liquidate the fund all together.”<sup>152</sup> Furthermore, Tsalik states that, “...parliament has no role whatsoever in Azerbaijan. This absence of a role for parliament does not fit with the Oil Fund’s function of serving to protect “the interests of citizens of the Republic of Azerbaijan and their future generations.” Members of parliament are elected by Azerbaijan’s citizens and, as such, should have a voice in decisions over how the country’s wealth is being stored and spent.”<sup>153</sup>

In stark contrast, there is a statement on the Fund’s website in response to the question, “Is SOFAZ activity beyond the authority and control of the Parliament?” which states, “No. Any suggestion that SOFAZ works beyond the reach of the Parliament is false. In accordance with the Law "About Budget System" of the Republic of Azerbaijan, all SOFAZ revenues and expenditures are incorporated as part of an annual consolidated government budget and approved by the Parliament. The Fund is audited by the Accounting Chamber, which is under the control of the Parliament and reports directly to the Parliament. Moreover, the Fund's activity is controlled by the Supervisory Board comprising governmental representatives and members of Parliament.”<sup>154</sup>

In terms of transparency, the Fund’s website is “also fairly comprehensive.” Transparency is referred to as a key objective in SOFAZ’s annual report and on their website, which includes the regulations governing the report, the annual report, and announcements of tenders. The annual report is also fairly comprehensive in its description of the legal and administrative framework of SOFAZ as well as containing the names of the members of the Supervisory Council and substantial financial data such as breakdowns of all proceeds from each revenue stream.

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<sup>152</sup> Tsalik, Svetlana of the Caspian Revenue Watch. *Caspian Oil Windfalls: Who will Benefit?* Copyright 2003 by Open Society Institute.

<sup>153</sup> Ibid.

<sup>154</sup> SOFAZ. “Frequently asked Questions.” <http://www.oilfund.az/en/content/21/85#2>

Furthermore the auditor's financial statements are included in the report along with their corresponding notes.<sup>155</sup>

SOFAZ has played an essential role in the mitigation of the resource curse in Azerbaijan. Since its establishment in 1999, it has helped mitigate inflation by sterilizing large amounts revenues from the oil industry, it has also been effective in absorbing price shocks which may have had potentially catastrophic effects on the oil-dependent economy. SOFAZ has also played a role in financing projects which have, and will continue to benefit Azerbaijan such as the BTC pipeline and the future BTK railway among others.

Overall the State Oil Fund of the Republic of Azerbaijan has been effective in an economic and social context. The role of the Fund as a socio-economic tool can be improved though to allow for an even more positive effect in years to come. Azerbaijan's resources are limited and the next twenty years are crucial to the future of the country and its population. To maximize the benefits the government should focus on improving the fund through the development of the legal and administrative rules as well as the establishment of stronger, clearer guidelines governing investment strategies. Furthermore the inclusion of civil society could enhance the independence of the supervisory council.<sup>156</sup>

## **5 - 2 – Transparency Initiatives and the Role of NGO's:**

Tracking resource development and the use of resource revenues is made possible by transparency. In many oil-rich countries there is a new tendency towards pursuing long-term stability for the sake of future prosperity. This trend is proven by the growing enthusiasm shown by governments of resource-rich countries to adopt transparency initiatives and international standards according to Dr. Ingilab Ahmadov, Director of the Public Finance Monitoring Centre (PFMC) and board member of the Extractive Industries Transparency Initiative (EITI).<sup>157</sup>

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<sup>155</sup> Tsalik, Svetlana of the Caspian Revenue Watch. Caspian Oil Windfalls: Who will Benefit? Copyright 2003 by Open Society Institute.

<sup>156</sup> Ibid.

<sup>157</sup> Ingilab, Ahmadov, PhD. "Why is Oil Contract Transparency Necessary?" September 14<sup>th</sup> 2009.

In resource rich countries, transparency in certain areas of the economy is essential to avoid pitfalls such as corruption, rent seeking, dubious contracts, and general bad governance. These areas of the economy include the state budget, macro-economic indicators, micro-economic indicators, government projects, contracts, and for countries with natural resource funds (NRF's), inflows and outflows of revenues from NRF's.

A major step forward in the quest for transparency in Azerbaijan was made on June 17<sup>th</sup> 2003, when the delegation, headed by the President of the Republic of Azerbaijan, declared their decision to join the Extractive Industries Transparency Initiative (EITI) and support international efforts for higher transparency in the extractive industries.<sup>158</sup>

#### **The Extractive Industries Transparency Initiative (EITI):<sup>159</sup>**

The EITI was announced by Tony Blair in 2002 the World Summit for Sustainable Development in Johannesburg, South Africa, and was launched in June 2003 in London.

The objective of the EITI is to raise transparency in payments to the Government by foreign companies, and, correspondingly, bring more transparency to the revenues of the State in the spheres that also cover the activity of companies.

**Benefits for implementing countries** include an improved investment climate by providing a clear signal to investors and international financial institutions that the government is committed to greater transparency. EITI also assists in strengthening accountability and good governance, as well as promoting greater economic and political stability. This, in turn, can contribute to the prevention of conflict based around the oil, mining and gas sectors.

**Benefits to companies and investors** center on mitigating political and reputational risks. Political instability caused by opaque governance is a clear threat to investments. In extractive industries, where investments are capital intensive and dependent on long-term stability to generate returns, reducing such instability is beneficial for business. Transparency of payments made to a government can also help to demonstrate the contribution that their investment makes to a country.

**Benefits to civil society** come from increasing the amount of information in the public domain about those revenues that governments manage on behalf of citizens, thereby making governments more accountable.

<sup>158</sup> EITI. "EITI Implementation in Azerbaijan." <http://www.oilfund.az/eiti/en/content/2/2/>

<sup>159</sup> EITI. <http://eiti.org/eiti/benefits>

To date, Azerbaijan is a leader in the number of reports submitted to the EITI, with 12 reports. “However, EITI reports in Azerbaijan do not provide opportunity for reviewing payments by separate companies and limits investigation opportunities in this field. Despite the numerous applications to extractive companies in Azerbaijan, most of them rejected from providing information stating it a commercial secret.”<sup>160</sup>

On May 13<sup>th</sup> 2004, the coalition “For Improving Transparency in Extractive Industries” was formed. This coalition was formed, “in an effort to ensure public control over the revenues obtained through the exploitation of the country's natural resources and their effective use.”<sup>161</sup> A coalition of Azerbaijani NGO's with the following objectives:<sup>162</sup>

- organization and implementation of public control over the safe storage, complete return to the state and effective use of Azerbaijan's share of the revenues obtained from the exploitation of the country's natural resources;
- implementation of the activities aimed at informing the Azerbaijani citizens of the exploitation of the country's natural resources and of the earned revenues, including the organization and implementation of public control over such activities of state bodies and companies;
- joining the efforts of civil society institutions in the area of transparency and in this way stepping up the level of public activity;
- ensuring the representation of Azerbaijani public associations in the British government's "Transparency Initiative in Extractive Industries", which has been joined by the Azerbaijani government.

The coalition is also a part of the “Publish What You Pay” (PWYP) campaign which is a global network of organizations united in the search for transparency in oil, gas and mining revenues. Their aim is to promote development and improve the lives of ordinary citizens in resource-rich

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<sup>160</sup> Sabit Bagirov. “Declaration of the EITI NGO Coalition of Azerbaijan”. July 31<sup>st</sup> 2010. [http://www.eiti-az.org/ts\\_gen/eng/news/2007/na-012.html](http://www.eiti-az.org/ts_gen/eng/news/2007/na-012.html)

<sup>161</sup> EITI. “Memorandum on establishing the Coalition "For Improving Transparency in Extractive Industries". May 13<sup>th</sup> 2004. [http://www.eiti-az.org/ts\\_gen/eng/koalisiya/eng\\_k2.htm](http://www.eiti-az.org/ts_gen/eng/koalisiya/eng_k2.htm)

<sup>162</sup> Ibid.

countries. “PWYP undertakes public campaigns and policy advocacy to achieve disclosure of information about extractive industry revenues and contracts.”<sup>163</sup>

The Public Finance Monitoring Centre is an Organization set up on June 1<sup>st</sup> 2003 under the financing of the Open Society Institute. “The Center based its activities on continuing the idea “Publish What You Pay” by George Soros and initiative “Extractive Industries Transparency Initiative” T.Blair, on the national level. At present PFMC is one of the more active organizations involved in this direction in Azerbaijan.”<sup>164</sup>

The PFMC’s partners include PWYP, EITI, EITI-Coalition in Azerbaijan, Revenue Watch, and SOFAZ, among others. Its goals consist mainly in achieving efficient management over public finances, promoting public involvement in the efficient use of public finances, and achieving more effective and transparent use of public finances.<sup>165</sup>

Other organizations and NGO’s operating in Azerbaijan for the promotion of transparency include Global Witness, Revenue Watch, and the Central and Eastern Europe Bankwatch, among others.

The prioritization of transparency by the government of Azerbaijan is one of the key elements which make the country so attractive to international oil companies (IOCs), such as BP. IOCs put great importance on their global image and operating in countries like Azerbaijan, that are well respected globally for their efforts to promote transparency, is a factor that contributes to a good company image. NGO’s play a major role in achieving higher levels of transparency in Azerbaijan.

According to Svetlana Tsalik, there are too many constraints placed on NGO’s in Azerbaijan, which results in an obstacle to public participation in the budgetary process. She states that the right of freedom of association is guaranteed by Azerbaijan’s constitution and further backed by its membership in the Council of Europe.

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<sup>163</sup> PWYP. <http://www.publishwhatyoupay.org/>

<sup>164</sup> PFMC. [http://www.pfmc.az/index.php?option=com\\_content&view=article&id=46&Itemid=53](http://www.pfmc.az/index.php?option=com_content&view=article&id=46&Itemid=53)

<sup>165</sup> Ibid.

The development of civil society groups in Azerbaijan has been difficult but with the success of such organizations like the PFMC and the EITI coalition “For Improving Transparency in Extractive Industries”, it is clearly visible that Azerbaijan is moving forward and encouraging progress is being made.

## **Conclusion:**

This research paper shows that Azerbaijan's authorities have made significant economic advances over the last ten years. The country has managed to avoid numerous pitfalls which have been seen in other oil-rich states, such as the massive accumulation of debt and oil revenue fueled spending sprees. The challenges Azerbaijan will face in coming years will be augmented by the short life span of its oil and gas reserves. Based on current predictions the country has a period of about twenty years to reduce poverty, and create opportunities for its population through the development of the economy. To do this it is essential to move away from the extremely high dependence on oil and gas and focus on the development of the non-oil sectors of the economy so as to ensure sustainable economic prosperity beyond oil and gas.<sup>166</sup>

It is important to bear in mind that the scope of this research papers is limited to the economic element of the resource curse, the other two elements being political and social. In purely economic terms I do believe, based on my findings that Azerbaijan is suffering from the "resource curse."

Despite government efforts, to date, elements of Dutch disease are visible (Chapter 3). An issue which is of concern, is that since Hoffman observed that Azerbaijan was showing a susceptibility to Dutch Disease in 1999<sup>167</sup>, there has been a continuous flow of concerns voiced by such sources as Svetlana Tsalik<sup>168</sup>, The Economist<sup>169</sup>, the IMF<sup>170</sup>, and many other sources over the last decade that the situation is not improving.

The high value of the currency (Manat), the low exports and high imports as well as the inflation rate show us that the oil-revenues are having a negative impact on the non-oil sector. There are counter arguments, stating that the REER's (real effective exchange rate) appreciation is relatively modest, and that, if Azerbaijan adjusts its oil spending downwards, the rate of high

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<sup>166</sup> Ibid.

<sup>167</sup> Hoffman, David. "Oil and Development in Post-Soviet Azerbaijan," NBR Analysis, vol. 10, no. 3 (August 1999), pp 5-28

<sup>168</sup> Tsalik, Svetlana of the Caspian Revenue Watch. Caspian Oil Windfalls: Who will Benefit? Copyright 2003 by Open Society Institute.

<sup>169</sup> The Economist. „Boom and Gloom.“ March 8<sup>th</sup> 2007. <http://www.economist.com/node/8819945>

<sup>170</sup> SperoNews. "Azerbaijan energy profile." July 9<sup>th</sup> 2008. <http://www.speroforum.com/a/15709/Azerbaijan-Energy-profile>



inflows of oil revenues will be sustainable. Despite this, judging by current spending patterns, there is a real danger of Dutch Disease in the economy. This conclusion is based on the current spending pattern of the government and the fact that 3 of the four primary trading partners of Azerbaijan (Italy, USA, and France) currently have much lower interest rates than that of Azerbaijan.

The efforts to direct foreign currency received from the sale of its oil and gas away from the state budget so as to mitigate the effects of Dutch disease, seem to be insufficient as inflation is on the rise as of January 2010 reaching above 5 percent despite a consistent drop throughout 2009.

It is visible that as oil revenues have increased, so have the expenditures from the state budget. There are also factors that point to inefficient government spending, such as investments in non-sustainable projects, so called “white elephants,” as well as ineffective projects such as infrastructure that “require reconstruction immediately after completion.”<sup>171</sup>

Furthermore there are multiple factors that indicate that de-industrialization has been occurring in Azerbaijan and appears to continue to do so. The agricultural sector is suffering from a lack of investment and movement of the labor force to alternative sectors. Despite decreases in poverty figures, poverty is still a serious issue in Azerbaijan especially in rural areas.

Another factor which points to the “resource curse” is the movement of the labor force away from the primary industries, such as agriculture, and investment to non-tradable sectors of the economy. This is accompanied by non-competitiveness of locally produced products on international markets.

Probably the most important choice made by Azerbaijan was to maintain full state ownership over its energy reserves, inviting foreign companies (IOCs) to assume the role of development, thereby minimizing the risk associated to oil discovery, extraction, and development. This is what has differentiated Azerbaijan from other post-Soviet states such as Uzbekistan and Turkmenistan, who have both maintained state ownership of their oil and gas reserves, but

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<sup>171</sup> Gorkhmaz Askarov. “Viewpoint: Azerbaijan’s White Elephants.” RFLERL. <http://www.rferl.org/content/article/1079690.html>

rejected direct involvement of IOCs. On the other hand, the Russian Federation privatized its extractive industry domestically and only allowed a limited amount of international involvement. In contrast, Kazakhstan fully privatized the industry by selling the majority of its shares to foreign companies.<sup>172</sup>

Despite these different approaches adopted after the collapse of the Soviet Union, these states all have certain characteristics in common. Due to the fact that the Soviet Union owned all the resources, these states all inherited the same political and institutional structure for the management of their oil and gas reserves, as well as centralized policy making, economic planning and regionally based administrative-territorial system.<sup>173</sup>

These elements constitute the particularity of Post-Soviet states such as Azerbaijan. These states have barely 20 years of independence and have based their growth and evolution on oil and gas resources, while simultaneously re-developing their institutional and political systems, social infrastructure, and laying down foundations for civil society.

The adaptation of existing systems and industry which had been highly centralized during the Soviet era and which received a heavy blow with the collapse of the S.U. has proven to be a difficult task. In the case of Azerbaijan I believe that a very significant amount of progress has been made in the last 20 years.

Contrary to the case of other resource rich countries in different regions, such as in Africa, Azerbaijan and other newly independent states began their oil-led development with the remnants of existing infrastructure, political, educational, and institutional systems as well as the industrial systems remaining after the collapse of the S.U.

Despite this, the driving force behind the rapid development of Azerbaijan is its extractive industry, which has led to the high economic dependence that is evident today.

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<sup>172</sup> Pauline Jones Luong, Erika Weinthal. "Prelude to the Resource Curse: Explaining oil and gas development strategies in the Soviet successor states and beyond." May 2001.  
[http://www.brown.edu/Departments/Political\\_Science/OLD/pauline/Prelude%20to%20the%20Resource%20Curse.p](http://www.brown.edu/Departments/Political_Science/OLD/pauline/Prelude%20to%20the%20Resource%20Curse.pdf)

<sup>173</sup> Ibid.

Many of the elements covered in this research paper point to the fact that Azerbaijan is suffering from the negative economic effects that are commonly associated with the resource curse. However the scale of these effects is not unmanageable. As mentioned previously, there have been many positive steps taken in recent years to counter these effects. The most important of which was the establishment of SOFAZ and the government's acknowledgement of the importance of transparency.

The Post-Soviet resource curse is a result of the oil-led rapid development of the economy which followed after the collapse of the Soviet Union. This left these newly independent states in a seemingly hopeless situation, politically, socially and economically.

On the economic front, I believe the main areas that the government should focus on, are the reduction of the country's dependence on oil and gas revenues and the investment in non-oil related industry so as to diversify revenue streams. Furthermore the ongoing efforts to fight poverty and unemployment should be stepped up. The government should seek to reduce inflation to promote competitiveness, as well as emphasizing the development of tradable sectors over non-tradable sectors of the economy. Finally efforts must be made to improve the legal and administrative structure of SOFAZ, as well as that of civil society in Azerbaijan.

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